ADMINISTRATION'S FISCAL YEAR 1983 BUDGET PROPOSAL

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

FEBRUARY 23, 24; MARCH 9, 10, 11, 12, 16, 17, 18, 19, 1982

Printed for the use of the Committee on Finance

Part 1 of 5

FEBRUARY 23, 24 AND MARCH 9, 10, 11, 1982

U.S. GOVERNMENT PRINTING OFFICE
91-115 O WASHINGTON : 1982 HG 97-79

S361-34

COMMITTEE ON FINANCE

ROBERT J. DOLE, Kansas, *Chairman*

BOB PACKWOOD, Oregon
WILLIAM V. ROTH, Jr., Delaware
JOHN C. DANFORTH, Missouri
JOHN H. CHAFEE, Rhode Island
JOHN HEINZ, Pennsylvania
MALCOLM WALLOP, Wyoming
DAVID DURENBERGER, Minnesota
WILLIAM L. ARMSTRONG, Colorado
STEVEN D. SYMMS, Idaho
CHARLES E. GRASSLEY, Iowa

RUSSELL B. LONG, Louisiana
HARRY F. BYRD, Jr., Virginia
LLOYD BENTSEN, Texas
SPARK M. MATSUNAGA, Hawaii
DANIEL PATRICK MOYNIHAN, New York
MAX BAUCUS, Montana
DAVID L. BOREN, Oklahoma
BILL BRADLEY, New Jersey
GEORGE J. MITCHELL, Maine

ROBERT E. LIGHTHIZER, *Chief Counsel*
MICHAEL STERN, *Minority Staff Director*

CONTENTS

ADMINISTRATION WITNESSES

Page

Regan, Hon. Donald T., Secretary of the Treasury ... 8
Volcker, Hon. Paul A., Chairman, Board of Governors of the Federal Reserve System ... 95

PUBLIC WITNESSES

AFL-CIO, Lane Kirkland, president ... 327
Albertine, Dr. John, president, American Business Conference, Washington, D.C ... 509
American Association of Retired Persons, James Hacking, legislative counsel .. 435
American Business Conference, Dr. John Albertine, president ... 509
Brookings Institution, Dr. Joseph Pechman, director of economic studies ... 171
Feldstein, Martin, president, National Bureau of Economic Research, Cambridge, Mass ... 160
Fellner, Dr. William, resident scholar, American Enterprise Institute for Public Policy Research, Yale University ... 189
Hacking, James, legislative counsel, American Association of Retired Persons and National Retired Teachers Association ... 435
Kirkland, Lane, president, AFL-CIO ... 377
Matheson, Hon. Scott M., Governor of the State of Utah ... 490
Meltzer, Dr. Allan, professor, Carnegie-Mellon University, Pittsburgh, Pa ... 180
National Bureau of Economic Research, Martin Feldstein, president ... 160
National Retired Teachers Association, James Hacking, legislative counsel ... 439
Pechman, Dr. Joseph, director of economic studies, The Brookings Institution, Washington, D.C ... 171
Rahn, Dr. Richard W., vice president and chief economist, Chamber of Commerce of the United States ... 509
Schweiker, Hon. Richard S., Secretary, Department of Health and Human Services ... 220
Snelling, Hon. Richard A., Governor of the State of Vermont ... 477
Stockman, Hon. David A., Director, Office of Management and Budget ... 304
U.S. Chamber of Commerce, Dr. Richard W. Rahn, vice president and chief economist ... 509

ADDITIONAL INFORMATION

Committee press release ... 1
Opening statement of Senator Robert Dole ... 1, 299
Prepared statement of Senator Charles Grassley ... 3
Prepared statement of Hon. Donald T. Regan, Secretary of the Treasury ... 15
Study by the Treasury on merger activity and bank credits ... 75
Prepared statement of:
  Hon. Paul A. Volcker, Chairman, Board of Governors, Federal Reserve System ... 134
  Martin Feldstein, professor of economics, Harvard University ... 163
  Joseph A. Pechman ... 173
  Professor Allan H. Meltzer ... 183
  Dr. William Fellner ... 191
Opening statement of Senator Lloyd Bentsen ... 217, 301
Prepared statement of Hon. Richard S. Schweiker, Secretary of HHS ... 228
Article from the New York Times, March 10, 1982 ... 302

Page

Prepared statement of Hon. David A. Stockman, Director, Office of Management and Budget 308
Prepared statement of Lane Kirkland, president AFL-CIO 383
Prepared statement of James Hacking 439
Prepared statement of Governor Richard A. Snelling 481
Prepared statement of Governor Scott M. Matheson 494
Prepared statement of Dr. John M. Albertine 512
Prepared statement of Dr. Richard W. Rahn 518

COMMUNICATIONS

Community Service Society of New York 544
Michigan Department of Health, Bailus Walker, Ph. D., director 540
O'Connell, Daniel K., executive vice president, Ryder System, Inc 541
Ryder System, Inc., Daniel K. O'Connell, executive vice president 541
Walker, Bailus, Ph. D., director, Michigan Department of Health 540
Letter and "A Case for the 'Investment Stimulus Fee' " by Mark Vayda 550

ADMINISTRATION'S FISCAL YEAR 1983 BUDGET PROPOSAL

TUESDAY, FEBRUARY 23, 1982

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 10:14 a.m., in room 2221, Dirksen Senate Office Building, Hon. Robert Dole (chairman) presiding.

Present: Senators Dole, Roth, Danforth, Heinz, Symms, Grassley, Long, Byrd, Bentsen, Matsunaga, Moynihan, Baucus, Boren, Bradley, and Mitchell.

[The press release announcing the hearing, background material relating to the administration's budget proposals, and the prepared statements of Senators Dole and Grassley follow:]

[Press Release No. 82-107 from U.S. Senate, Committee on Finance]

COMMITTEE ON FINANCE SETS HEARINGS ON ADMINISTRATION'S BUDGET PROPOSAL

Senator Robert J. Dole (R., Kansas), Chairman of the Committee on Finance, announced today that the Committee will hold hearings on those parts of the Reagan Administration's budget proposal for fiscal year 1983 that are within its jurisdiction beginning on February 23, 1982.

The hearings will begin at 10:00 a.m. in Room 2221 of the Dirksen Senate Office Building. On February 23, the Committee will receive testimony from Secretary of the Treasury Donald T. Regan. On February 24 a panel of economists will present testimony.

These hearings will be followed on March 8 by Office of Management and Budget Director David A. Stockman, and on March 9 by Secretary of Health and Human Services Richard S. Schweiker.

The Committee has reserved March 10, 11, and 12 to hear from persons wishing to testify on the spending cuts in the Finance Committee jurisdiction outlined in the Administration's proposed budget.

Four days of testimony from March 16 through March 19 will also be reserved for persons wishing to testify on the tax proposals in the Administration's budget.

Hearings on the Administration's New Federalism proposal will be held by the Committee in late March.

OPENING STATEMENT OF SENATOR DOLE

I am pleased to welcome Secretary Regan this morning to help us begin our review of the administration's proposed budget for fiscal year 1983. This budget already seems to have been thoroughly dissected by the press and pronounced dead or dying by more than a few commentators. I would think that is premature: If we close off debate before we even get started, we have no hope of taking responsible action.

I have said that this is a credible budget, and I still say so. I do not agree with everything in it, and other members have much stronger objections than I do to some of the proposals. But I think we must agree that the budget aims in the right direction—it provides for slow but steady reduction of the Federal budget deficit over the next 5 years. While many would prefer a different mix in the budget, I think it is clear that we must do at least as much as is proposed in the budget to bring the deficit down. In fact, I believe we have to do more: And I look forward to working with you and with the President to bring the 1983 deficit significantly below the $92 billion range that you project. Even that range can be reached only if we approve the administration's entire $55 billion deficit reduction package. It will not be easy.

TIME IS OF THE ESSENCE

Let me note for the record that there have been some reports in the press that the administration is hoping for a protracted budget battle in Congress that will delay action on these spending and revenue proposals. According to this scenario, the hope is that later action on the budget will take place under more favorable economic conditions, and that the President may get more of what he wants.

I do not believe those reports and I feel that such a strategy would be a serious mistake. The economy may well turn up sooner than some now expect, and that may help pass a budget that is acceptable to the President. But what we are all trying to do, I think, is to promptly pass a budget that will increase the likelihood that the President will achieve his economic goals sooner, rather than later. That, I believe, is a goal everyone in this room shares. Continued floundering on the budget would convince the Nation that fiscal policy is out of control: and that can only undermine confidence in the economic program.

We can work together to fashion a budget that the President and the Congress can live with. We cannot do it if we spend half the year working at cross-purposes.

A BALANCED PROGRAM

Having said that, let me reiterate that the President has submitted a sound budget. It moves in the right directions, but it may not move far enough.

What is important, it seems to me, is that we make clear to the American people our intention to take a balanced approach to the problem of deficit reduction. We cannot afford to give credence to the notion that the deficit is reduced only at the cost of the least fortunate. The deficit is everyone's problem: everyone should have an opportunity to contribute to its solution.

I know that the administration has tried to reflect its concern for equity in this budget. By proposing user fees and entitlement reforms, I believe the administration is facing up to the need to spread the burden around. I agree with that, but some of us feel that we need to go farther, and ruling major elements of the budget out of bounds—in the defense area, in entitlements, and on the revenue side—makes the job much more difficult. Everyone benefits from Federal programs—everyone should tighten their belt a little. Unless the economic program is received as fair and equitable, public support will dwindle away. Americans will pitch in when they understand we are all engaged in a common effort.

REVENUES

I think we can agree that revenue increases cannot be a substitute for spending control. That has been the case too often in the past. But I think we also have to agree that some revenue-raisers must be a part of any deficit reduction program.

The President has acknowledged as much by proposing $32 billion in revenue-raising measures over the next 2 fiscal years. Some of the proposals in that package are not going to be enacted. I say that not to pass judgement, but to convey my sense of where Congress stands on some of these matters.

We will have to work with you, then, to find appropriate substitutes. Given the scope of the deficit problem, I expect that we will in the end have to do more than the President asks in terms of new revenues. I hope that your testimony today will give us some sense of what other options the administration is willing to entertain.

Let me assure you that it is not the intention or desire of this Senator to interfere or tamper with the essence of the tax reduction program passed last year. That program was approved by a strong bipartisan consensus, and indeed the alternatives offered to it would have cost as much revenue in the near term. We all hope that the tax program will prove to be the engine of economic recovery, and it must be given a chance.

That is not to say that every item in that package is free from scrutiny. I have advocated cutting back on the leasing provision because it has proved to be a problem: It has given unintended benefits to some who are not in need, and it entails a $27 billion revenue loss that cannot be justified to the public in terms of economic potential. As a matter of equity we will have to pare back leasing, and I hope the Treasury will help us do that in the most equitable way possible.

With regard to the tax program as a whole, however, I expect there would be little sense for Congress to attempt a major rollback. I know the President believes in this program: He has demonstrated that time and again. I expect he would veto any attempt to cut the tax program. There is no point in spending the year spinning our wheels. There are many ways to raise revenue without interfering in a significant way with the new tax incentives.

MONTHS AHEAD

The next few months may show a healthier economy, and that would make all of our jobs easier. But even the administration, at this point, does not seem certain what to predict. That is why it is vital for us to move ahead with measures that make sense regardless of the pace or timing of recovery. Measures, that is, to reduce the deficit in an equitable way without undermining the basic economic program. Given the scope of last year's tax cut, I believe we have a margin of revenues to work with that would not interfere with the goals of increased saving and investment and greater productivity. If those revenues are tapped in the proper manner, and only for the goal of reducing the deficit, we will greatly improve the odds in our favor.

There is considerable uncertainty in the economy right now. But while the course of recovery is hard to predict, there is a growing consensus that the main obstacle to recovery is the prospect of continuing high interest rates. Clearly whatever we can do to reduce the deficit, and cut the Government's borrowing needs over the next few years, will help bring interest rates down. Perpetual deficit financing is not the way to ensure stable growth. Our goal has to be to reduce Government borrowing without unravelling the growth-oriented tax program. The alternative is renewed inflation or economic deadlock.

This administration has great accomplishments to its credit. The first sustained and successful assault on inflation, a dramatic restoration of equity for the American taxpayer; the largest budget reductions in history, and a defense program that promises to end years of slippage vis-a-vis the Soviet Union. These are goals I support without qualification. But this is no time to lose our nerve in pursuing these goals. They must be pursued in a balanced and coordinated fashion. None of them can be achieved without a strong economic framework. We are here to help you complete that framework, and I hope we can do so by expediting action on this budget.

I am sure the members look forward to hearing your views on our economic prospects, and on the receipts proposals included in the President's budget.

PREPARED STATEMENT OF SENATOR CHARLES GRASSLEY

Mr. Chairman, I look forward to the comments of the distinguished Secretary of the Treasury on the contents of the long-awaited revenue enhancer package. We have all been trying to discover what course these reforms will take since last September. I hope your testimony will reveal precisely which steps the Treasury plans to take to collect additional revenue. It has been difficult to have an informed opinion these very controversial issues with the five sentence explanations the Treasury has helpfully provided.

As a member of both the Finance and Budget Committees, I have a strong interest in achieving a balanced budget. Obviously, efficient and fair revenue collection is important in achieving that goal. Nevertheless, I question the wisdom of setting forth specific tax policy changes in the budget document. Fortunately, this committee is chaired by an individual the Wall Street Journal called the most powerful man in the Senate yesterday, so I am optimistic we may not lose all of our jurisdiction to the Budget Committee. All of of us are concerned that the Budget Committee may begin requiring we adopt "savings" in certain tax areas, rather than giving us aggregate totals.

First, let me commend you for your work on an alternative minimum corporate tax. I think this is an excellent idea, in fact when the second session resumed I introduced legislation asking the Treasury to review this issue. Obviously this project was onging within the Treasury, but you speed in answering my request is worthy of praise. I am very interested in learning which preference items you have included within the alternative minimum tax base.

The equal access to Justice Act permits an individual to collect attorney's fees if the Government can establish that its position was substantially justified.

The Equal Access to Justice Act applied to all tax cases brought in district court. Recently, the Senate Finance Committee, the Senate and the House passed a bill enabling individuals in tax court to recover their attorney's fees if they could establish that the Government's position was unreasonable. This bill is now in conference. I note with dismay that the administration is attempting to limit the recovery on legal fee awards to the Government's cost in preparing a case. I do not favor the actions of the administration in negating an important piece of legislation through the budget process. This is a sneaky and dishonest way of undoing this legislation. If a taxpayer can show that the Government's position is substantially without justification or unreasonable, why should that taxpayer be denied compensation for what it cost him to establish that claim? Why is the Government's cost relevent? While I realize Secretary Regan may not be directly responsible for this underhanded action, I plan to offer an amendment in both the Finance and Budget Committees to strike this offensive provision from the budget.

I'd like to thank the chairman for scheduling this hearing and I am anxious to hear the details of the revenue enhancement package before the committee.

The CHAIRMAN. Mr. Secretary, we are pleased to welcome you to the committee.

I understand, if it is all right with everyone else, that Senator Roth has a very important hearing in progress, and that he would like, out of order, to make a confession or two—or a statement. Excuse me. [Laughter.]

Senator ROTH. Thank you, Mr. Chairman.

Mr. Secretary, first I would like to congratulate this administration for the initiatives that it has taken to create an environment of growth. It is the first time in the many years I have served in Washington where I have ever seen an administration really concerned about productivity, concerned about putting policies in place that will get this country moving again.

And I would just like you to know that I am shocked—not shocked, outraged—outraged by the business community reaction. For years I have heard big business, the big banks tell us this: That you lower taxes, you do something about regulations, and we'll respond; we'll show what this economy can do. And ever since we have put these things in place, to me they have been a bunch of crybabies. They have not responded.

In fact, if I were President, I would take another leaf out of Jack Kennedy's book, and I would call them to the White House and tell them, "We've set these policies in place; what are you going to do about it?" And if they didn't respond, if they talked about deficits, I'd just point out that there is something like $50 billion in tax cuts above what the President asked. As a matter of fact, they are going to have something like $150 to $200 billion in tax cuts the next 3 or 4 years, and if they want to do something about the deficit, I'll be glad to lead the charge to raise those business taxes.

But Mr. Secretary, I can tell you one thing: There are those of us that will fight, will filibuster, if they try to impose taxes on the working people of America. We are not going to balance the budget on the backs of the working people of this country. I just want to underscore that and make it very clear that there are many of us with you, and we will work with you.

I am concerned that business is a little bit like the hitchhiker who catches a ride with the public. And now, after they get in the car they want to steal it; they are not satisfied. They took a ride on the across-the-board tax cuts, and now they want to steal the car.

In closing, just let me say I am also concerned about these high interest rates. When I get the chance, I want to ask you: Have you thought about a windfall profits tax on big business or on the big interest rates? You know, I have always understood that banks, if they got the cost of living plus 2½ to 3 percent were doing damn well. Well, they are charging a lot more, so maybe we ought to think about a windfall profits tax there.

Mr. Chairman, I just want to say I appreciate your courtesy to me. I just want the administration to know that they have got some strong support here.

The **Chairman**. Thank you very much, Senator Roth.

Are there other opening comments?

[No response.]

The **Chairman**. Under the early-bird rule, you would be next, Senator Bentsen.

Senator **Bentsen**. Well, I might comment.

Mr. Secretary, the President said for us to go home and listen to the people, and I have done that. And I'm from a State that is doing rather well. But I don't know when I have heard as much apprehension about the economy as I heard at home. I don't know when I have heard as much about high interest rates and the concern of small business and the farmer and the home builder to try to get these rates turned around. I think we are going to see an increase in unemployment unless we can do that. And a big part of this deficit is the increase in unemployment we have seen thus far.

So anything we can do to get a stable and a moderate increase in the money supply and to cut this deficit is what I want to do as a member of this Finance Committee. I think we are going to have to look at some of these things that were done in this tax bill that I think will result in an excess with what we are facing today.

Thank you very much, Mr. Chairman.

The **Chairman**. Senator Byrd?

Senator **Byrd**. Well, I want to express alarm at the size of the projected deficits. I feel that they represent a great potential danger to the Nation, to the recovery program. And I would hope that the administration would focus more emphatically on the need to reduce the magnitude of what I consider to be very dangerous and alarming deficits.

The **Chairman**. Senator Danforth?

Senator **Danforth**. No.

The **Chairman**. Senator Baucus?

Senator **Baucus**. Thank you, Mr. Chairman.

Mr. Secretary, I would like to followup a little on a point made by Senator Bentsen. During my week home, I found very much the same reaction. And I had many different kinds of meetings—I had town meetings, as many Members of the Senate have, met with business groups, with bankers, with savings and loan officers—and I must say, probably more often with Republicans this last week than with Democrats. And I can tell you it is very interesting, the reaction.

First of all, everyone—and that is not an exaggeration—suggested that we have to get interest rates down by cutting the deficit. They first began with the defense budget. They say the defense budget projected growth is just way too large. And these are businessmen, these are bankers, these are people generally on your side of the aisle.

Second, they wanted to do something with the tax cuts that we passed last year. There was a virtually unanimous feeling that the tax cut was too big. They wanted to cut some of the business taxes—safe harbor leasing, for example, was not high on their list of favorite tax measures that we passed last year. They felt that we should perhaps do something with the individual income tax reduction that we passed last year as well.

All I can say is that the feeling was very, very strong; it was across-the-board; and there was a consensus that to get interest rates down we have to get the deficit down. And everyone I have talked to is willing to do what is necessary to get that deficit down much more quickly than they see it programed out to be under the administration's program.

The **Chairman**. Senator Heinz?

Senator **Heinz**. Mr. Chairman, I just want to say to Secretary Regan, we are delighted to have him, and also to report to him that, having spent the last week in my State of Pennsylvania, that there is a considerable amount of disenchantment with the huge deficits; there is alarm about high interest rates; there is real depression about high unemployment; and there is a grave and widespread feeling that on the revenue side we don't have our act together. And this is from people at large.

On the business side, I must say there is great concern that some of the things that you will propose here today go completely against the stated objectives and goals of the administration. If, for example, you want to have incentives for enterprise zones, but you, through a minimum corporate tax, make those incentives unattractive, if you want investment tax credits and accelerated appreciation to reindustrialize America, the question is: How do you justify taking a half, a third, or two-thirds of those incentives away the very next day? In other words, the problem is: Is the administration going to go through an on-again, off-again kind of tax policy, the kind of policy shifts that both Republicans and Democrats used to criticize Jimmy Carter for?

I think we value consistency greatly here, because it builds confidence. Frankly, at the present time and given much of what has been said, we are not building a lot of confidence.

Finally, I think that we really are at the point of very serious, grave, even violent political reaction to interest rates that are double the rate of inflation, and that the high interest rates that we have, being 6, 7, 8 points above the inflation rate, cannot be explained rationally to people who ask the question: If these interest rates are so far above the inflation rate, who is getting the difference—and why—and what are you going to do about it?

Now we all know that some patience is required in order to give economic policy—ours, yours, anybody's—a chance to work. But I must tell you, Mr. Secretary, that there is just extraordinarily grave concern building about these high interest rates that affects the autoworkers who are laid off because cars can't be sold, it affects the homebuilder and the homeowner who can't purchase the home, it affects the businessman who can't afford to borrow. It is driving all of these people to the wall.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Moynihan?

Senator MOYNIHAN. Mr. Secretary, may I be the last to welcome you to this committee and to tell you what you need hardly be told, that in our year together our respect for you has grown, and particularly for the directness with which you have responded to our questions in a context where there has been something missing by way of directness in other parts of the administration, or so some of us feel.

As you probably know, there is a strong sense that once again we have been sent a budget with the numbers cooked, that the deficits are much larger than even the extraordinary deficits that are projected. And, indeed, the accumulated deficits of the next 3 years could be half a trillion dollars, in 3 years making it as far as we have come in 200.

We therefore depend so much on you, because you have never tried to mislead us, and you have always acknowledged the range of uncertainty in any economic forecasts. But when you have a chance, and after you have testified, I would like to ask you about the recent article in Fortune by Paul Craig Roberts, who was your Assistant Secretary of the Treasury for Economic Policy, your basic planner and forecaster in that regard, who resigned from the administration in December and in January wrote an article in Fortune which is simply entitled "The Stockman Recession—A Reaganite's View." He says that the recession that we now are in was brought about by the policies of the Director of the Office of Management and Budget, Stockman.

If you recall, in The Budget in Brief, you have a little description of why we have the huge deficits in 1983 that you are projecting at 91.5 but which perhaps some will say something more like 130.

Well, the first reason is the recession, which was unexpected and produced part of that budget deficit. But I would like to know, do you agree with your former Assistant Secretary of the Treasury for Tax Policy that the administration brought on this deficit, or rather that Mr. Stockman did? Or do you think it was sunspots, or whatever?

Then I would like, and I think we all on this side would like, a certain exploration of the interesting new idea from our Republican colleagues that there should be a windfall profits tax on big business. I would like to hear what you think about that.

The CHAIRMAN. He can't answer those yet.

Senator MOYNIHAN. I just thought that sometime he would like to.

But, welcome, Mr. Secretary. [Laughter.]

The CHAIRMAN. Well, Mr. Secretary, we wanted the members to comment so you would know in advance what you are probably in for. [Laughter.]

And it is wide ranging. We have very fertile minds in the staffs, and they come up with all kinds of things.

But I have a very outstanding statement, which I will put in the record. [Laughter.]

And say that I am very pleased to have you before the committee this year to start the discussion of the budget. Now, if you listen to some of the media, it has already been decided; it's been buried and forgotten. I don't think that is the case, and I don't fault the media because it has been rather slow around here. But we're back now, and we can really get into the work of discussing the budget and where we must go.

I must say that I find the budget credible, if I look at the CBO numbers and Chase Bank and DRI. I don't really find that much dispute with the assumptions used by the administration. So I think it's a credible budget. That doesn't mean I agree with everything in the budget; I don't think any of us do or any of us ever had agreed with everything in any administration's budget.

I know there are great concerns about interest rates. Like every other Member of Congress, I determined that without going home. I went home, but I knew in advance that there was concern about interest rates.

I do believe there are areas where we can make changes in the tax bill passed last year. In fact, I recall making a statement on the Senate floor in response to an inquiry by one of my colleagues that if in fact we found provisions that were too generous or not working, then we would take the initiative. And I did that, as you may recall, last Friday on the leasing provision. I don't recall your statement after I did that; I don't know that you recall the statement. So I think that's a responsibility we have as a committee, and certainly we are not going to make any final judgments without the input of the administration.

I think, also, it would seem to me that we have a great opportunity based on a 1968 precedent to use the debt ceiling—we are going to be raising the national debt here, and we are going to have to pass another debt ceiling increase bill. That will come fairly early, and it would be a great time, in my view, to put in the whole package on that debt ceiling which I believe would send interest rates down very quickly, if we can find some bipartisan agreement on an economic package, changes that we are going to make from the standpoint of revenues and spending. That was done in 1968. It originated in the Senate Finance Committee under the outstanding leadership of Senator Long. So I am very optimistic about the future.

It is customary, I understand, that when a chairman retires their picture is hung on the wall. And if things don't improve, my picture may be up there before Senator Long's. [Laughter.]

So I am very hopeful that all these things will work that I have been voting for. [Laughter.]

Having said that, we are pleased to have you. We do very sincerely look to you as the leader of the economic force in this administration. We appreciate your candor. We know it's based on experience. And I don't know of a single member of this committee who is not willing to sit down with you, Mr. Secretary, and try to work out a bipartisan effort to do what we all know must be done. Thank you.

STATEMENT OF HON. DONALD T. REGAN, SECRETARY OF THE TREASURY

Secretary **Regan**. Thank you, Mr. Chairman, and thank you, gentlemen.

President Reagan's budget is a blueprint for growth and for prosperity. It is a plan for reducing Federal spending and the tax burden. It is a plan for increasing the family budget. For the first time, we are asking the right people to tighten their belts: the Federal Government.

We have painstakingly gone through every item. All members of the Cabinet have met with the President on their programs. And we have fashioned a budget that responds to the President's call for a new federalism; it meets the complex needs of our society; and it reduces the rate of growth in Government.

This budget contains dramatic reductions in Government spending, yet it's important for people to know that we are not tearing down the house nor ransacking the furniture. We are simply trying to stop the runaway growth of past Federal spending and restore a measure of commonsense to how we spend the people's money.

So let's take a quick look at how this budget was put together.

On the revenue side, we expect receipts totaling $666 billion for fiscal 1983, of which $304.5 billion comes from individuals, $65.3 billion from corporations, $222.5 billion from payroll taxes, and the remainder from excises, Federal Reserve earnings, and the miscellaneous taxes and fees.

More importantly, we have in place a sound long-run tax system for the 1980's, one that will promote rapid growth of income, savings, investment, and employment for years to come. That tax system, with a healthy economy, will generate as much revenue as Government should reasonably be allowed to spend.

However, the revenue picture has been heavily affected by two factors: the recession and a drop in inflation—one bitter pill and one piece of candy which together have significantly decreased revenue to the point of causing large deficits. The recession is temporary, and the decline in inflation most welcome.

We therefore had to face some tough decisions about how to cover the costs of some very important Government programs—how to make up the difference between $666 billion in revenues and the $757.6 billion in outlays—until the growing economy triggered by our reformed tax system brings growing revenues into line with restrained outlays.

Some have urged us to revoke the incentive-creating tax cuts already in place. The results would have been lower real growth for many years into the future. It would have involved a self-defeating major change in a permanent tax program to handle a temporary problem. That alternative was not seriously considered. Instead, we shall propose certain worthwhile tax reforms, upgrade our tax collection program, renew our efforts at controlling spending, and borrow to cover the remaining deficit.

Deficits are not good. They rob the private sector of financial and real resources needed for growth and divert those resources into Government consumption. So do taxes. The root of the problem is the Federal spending which appropriates those real resources and then must find the means to pay for them in one way or another.

The budget deficit can and must be narrowed from the spending side. For too long, spending has been rising faster than the economy has grown. The economy can no longer support the burden. Some progress was made last year in reducing the runaway rate of growth in Federal nondefense spending. Further efforts will be required this year and into the future.

Insofar as spending is not reduced, it is preferable to close the remaining transitional recession deficits of the sort now being experienced by borrowing rather than by taxing. The funds are pulled from the private sector in either case, but taxes impose a larger cost in terms of reduced incentives for real growth.

We must continue to strive to reduce the deficit by curtailing spending and promoting real growth. The budget and the outlook that we are proposing take major steps toward closing that deficit over the next several years. In the interim, it can be handled in a nondisruptive fashion. Let me put the deficit into perspective.

The projected deficits, though some of them are at record dollar levels, are not unusual following a recession when measured as a percent of gross national product. The first attached chart shows deficits as a percent of gross national product since 1975.

On-and-off-budget deficits were 3.6 and 4.5 percent of gross national product in fiscal years 1975 and 1976, due largely to the 1974–75 recession. Deficits are projected to be 3.8 percent and 3.1 percent of GNP in fiscal years 1982 and 1983, largely as a result of the current recession. There has been considerable concern that our projected deficits will put extreme pressure on credit markets and thus drive up interest rates. However, deficits do not cause high interest rates. The historical record shows no direct association of deficits and interest rates; the second chart shows that in years with large deficits, interest rates went down more than they went up. Interest rates are determined by the real rate of return on capital, the expected inflation rate, and a premium for risk. Although deficits could conceivably influence expected inflation and risk, this would not happen, according to the latest Federal Reserve Board report, unless they were accompanied by excessive money creation.

As you all know, this administration has adopted a policy of slow and steady growth in the money supply. We are in agreement with the Federal Reserve Board's fight against inflation, and we support their announced intentions to reduce money growth rates gradually from year to year. Although we are concerned about the affect of volatility in money growth on interest rates, we intend to work closely with the Fed in order to reduce those unhealthy fluctuations.

The deficits will be manageable because of the growth in private sector savings, as shown in the third chart.

Private savings resulting from normal year-over-year growth, and from the Economic Recovery Tax Act will be several times greater than the total borrowing requirement of the Federal Government in 1983 and 1984 and thereafter.

The net additions to total private savings are larger than the rise in the deficit. This will produce crowding in rather than crowding out. This extra shot in the arm of capital markets will put downward pressure on interest rates. Even after financing the Federal deficit, there will be billions of additional dollars each year for private investment.

Normal year-to-year increases in savings exceed $40 billion. This will be supplemented by the additional personal savings and additional business retained earnings induced by the tax cuts.

Compared to 1981, private savings will be more than $60 billion higher in 1982, more than $170 billion higher in 1983, and more than $260 billion higher in 1984. Private savings was just under $480 billion in 1981. It will rise to more than $740 billion in 1984.

It has been lack of growth, more than anything else, that has been responsible for the current and projected deficit. As a rough rule of thumb, each time growth falls off by enough to produce a 1-percent increase in unemployment, the budget deficit widens by more than $25 billion. In fact, if we had grown fast enough over the past 4 years to get unemployment down below 6 percent, the current deficit would be $75 billion lower.

Growth is the only way to balance the budget while promoting rising real income and employment. If the economy were growing at 4 to 5 percent per year in real terms, Federal revenues would be rising $30 to $35 billion per year in real terms, even under an indexed Tax Code without the windfall to the Federal Government from bracket creep. That is how fast the deficit would be falling in 1982 dollars if real spending were being held constant. We have not asked for spending restraint of that magnitude, choosing a more gradual path toward budget balance. After a slight dip in real outlays in fiscal 1983, real outlays are projected to grow approximately one-third as fast as the economy in the next 4 years. However, we would be willing to look at further spending restraint if Congress wishes.

I would like to point out very firmly that any changes in the economic recovery program which reduce real growth will tend to worsen the budget picture. Changes which reduce individual or business savings by as much as or more than the deficit will only worsen the situation in the credit markets.

The budget is not merely an accounting document. One cannot simply take a billion dollars out of column A and put it in column B. There are behavior changes and economic repercussions from tax and spending shifts which affect savings, investment, labor supply, income, and revenue. Very often, changes which may look good on paper will buy little or no progress toward solving a budget problem, especially compared to the economic cost to the whole Nation of a policy shift.

These facts should be kept clearly in mind as we look at the deficits in the budget.

As President Reagan points out in his budget message, our success in reducing inflation has reduced tax receipts. Over the next 5 years, we project a steady fall in inflation. Yet if nominal GNP growth were just 2 percent higher each year, reflecting a continuation of higher inflation, Federal receipts would be enlarged by $353 billion over the next 5 years as inflation and the progressive Tax Code pushed taxpayers into higher brackets. After allowing for inflated outlays, the budget deficit would be $38½ billion lower in 1987.

In the past, this is how administrations and Congresses planned to balance the budget. We have a better plan. We intend to balance the budget through spending restraint, lower taxes and higher real growth, not through inflation. In the short run there will be substantial deficits, due primarily to the recession; however, we are confident that personal and business savings over the next few years will be adequate to finance both the projected deficits of the total Government sector and a very rapid increase in real capital formation.

I realize that there has been concern over the apparent reluctance of business to plunge ahead with new investment. It is not surprising that some businessmen are holding back until it is certain that it's safe to proceed. A lot of them are waiting for lower interest rates. Others are waiting to make certain that Congress will not make drastic changes in the Economic Recovery Tax Act, so they can plan with confidence. Nothing kills investment faster than uncertainty. Once these problems are resolved, the investments will be there.

While the administration is opposed to increasing statutory tax rates, rates which apply at the margin to taxpayers who work, save, and invest, at the same time it is committed to insuring that the tax system is run efficiently and fairly. Thus, while we do not support increases in marginal rates for taxpayers, we do propose changes in three areas: One, an elimination of abuses and obsolete incentives within the system; two, a major effort to improve tax collection and enforcement; and three, enterprise zone tax incentives and miscellaneous efforts to charge users of various Federal programs for the benefits they receive.

We want to eliminate abuses and to remove obsolete incentives within the system. In many cases, abuses arise because the use of special types of financial arrangements or legal devices allow one taxpayer to pay a much lower tax than a similar taxpayer engaged in exactly the same activity. Through the accelerated cost recovery system and other provisions included in the Economic Recovery Tax Act of 1981, Congress, working with this administration, has lowered effective marginal tax rates on all types of business activity. We do not, however, support haphazard and arbitrary reductions in average tax rates for specific groups of taxpayers.

Eliminating tax abuses is entirely consistent with the administration's overall economic program. The abuses that we propose to eliminate generally do not provide desirable incentives. Even when they might affect marginal tax rates, the effect is so distorted and so difficult to disentangle from other effects that hardly any desirable incentive is provided. Indeed, when a tax provision provides benefits only to a business or individual with special financial and legal arrangements rather than to all taxpayers engaging in a simliar activity, then it may end up subsidizing less efficient taxpayers with competent counsel over more efficient ones who rely on less competent legal and financial advice.

Our proposals in this area will be the following: Legislative and regulatory changes to eliminate unwarranted tax benefits arising from the completed contract method of accounting, repeal of the business tax credits on energy; restricting tax-exempt bonds for private activities, legislative and regulatory changes to eliminate unwarranted tax benefits rising from modified coinsurance arrangements, capitalization of construction period interest and taxes by corporations; and adoption of an alternative corporate minimum tax.

This administration proposes also that Congress join with it in improving tax collection and enforcement. Insuring that taxes due the Government, in fact, are actually paid by taxpayers and they are paid on a timely basis is necessary to the maintenance of a fair and workable tax system. If nonpayment of taxes is allowed to go unchecked, it can slowly eat away at the well-being of our system that relies on voluntary compliance. If individuals instead are convinced of the uncertainty yet fairness of the enforcement efforts, and they know that no taxpayer will be given preference in paying taxes as income is earned, then the system can work well. Taxpayers will comply honestly and support a system which they think is fairly administered. However, if the Government fails to make adequate efforts at enforcement and adopt proper methods of administration, then the support will erode.

Strengthened enforcement and improved tax collection are entirely consistent with the administration's economic program. Improved compliance and timely payment of taxes owed does not raise statutory tax rates and has almost no effect on the rate of return from savings and investment, but it does reduce the opportunities and benefits from underreporting income.

Those who underpay their taxes indirectly raise the tax rates of those who report all of their income and pay their taxes on a timely basis. It would be foolish to argue that efficient productive incentives are provided by our maintaining a system in which it is easier for some persons to underreport income or to pay taxes later than others must.

Our proposals in the collection and enforcement area will be the following: withholding on interest and dividends, corporate income tax speedup, and IRS staff increases.

While the administration is committed to a program of improved tax collection and enforcement, we are not wedded to these proposals only. We look forward to congressional input into this program and believe that your suggestions for improving collection and enforcement efforts will be vital to developing an overall bill. I feel confident that the resulting bill will be fair to the American people, yet at the same time will address in a forthright manner problems of compliance, administration, and timely payment of taxes.

Finally, the administration has proposed and will continue to develop initiatives to improve upon incentives in the economy, to insure that direct beneficiaries and users of various governmental services are required to pay for some of these services and to make more rational and consistent the operation of existing programs.

Within a day or two, or hopefully this week, we will be releasing comprehensive explanations of our proposals for major tax revisions and for improvements in tax collection and enforcement. We are also preparing legislative drafts which we will send up as soon as they are completed.

In my written testimony, I have provided you with some brief details on each of our proposals.

Now, in conclusion, Mr. Chairman, we have in place a tax system for the 1980's that will promote the growth of income, savings, investment, and employment for years to come. Eliminating the incentives just adopted by Congress and choosing instead to steadily increase tax rates would only be a return to the policies of the past—policies that have been tried and failed.

The budget deficits can and must be narrowed, but from the spending side, not the tax side. While the recession will cause substantial deficits in the short run, it is only higher real growth in the long run that will restore our Nation's health. Raising tax rates will only exacerbate our problems by lowering possible future growth.

While the administration is opposed to raising tax rates in general, it recognizes the need to insure that the tax system is run efficiently and fairly. We support a program to eliminate abuses and eliminate obsolete incentives, to make major improvements in tax collection and enforcement, to create enterprise zone tax incentives, and to make efforts to charge users of various Federal programs for the benefits that they receive.

Let me throw out a final challenge to those who might oppose the administration's tax program. I recognize that there are those who did not and do not support reductions in rate of tax for individuals and businesses, and I recognize that there are those who oppose the initiatives that we have presented here today. What I find most incomprehensible, however, are those persons who can oppose both. At least in part, these individuals can only be proposing that an increase in tax rates on all taxpayers is a better means of raising revenues than eliminating abuses and obsolete incentives, or improving compliance and enforcement programs. This type of choice, however, favors special interests, those who are able to engage in complex financial and legal arrangements, those who underreport their income, those who do not pay taxes on a timely basis, and users of services who do not pay for the benefits that they receive. Such favoritism is not warranted for two reasons: First, it is blatantly unfair to the taxpayer who willingly and honestly pays his fair share of the tax burden; and, second, as a substitute for direct rate reductions, it provides much less incentive for restoring our Nation's economic health.

Mr. Chairman, I do not believe that most members of this committee will favor special interests over the average taxpayer. I invite each member of this committee to work with us on the proposals that I have outlined for you. Indeed, I look forward to your suggestions for ways to strengthen our efforts to eliminate abuses and obsolete incentives, to improve compliance and enforcement, to create enterprise zone incentives, and to charge users of various Federal programs for the benefits that they receive.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Mr. Secretary. Your entire statement will be made a part of the record. I know you summarized it, and we appreciate that.

[The prepared statement of Secretary Regan follows:]

STATEMENT BY
THE HONORABLE DONALD T. REGAN
SECRETARY OF THE TREASURY
BEFORE THE
SENATE FINANCE COMMITTEE
TUESDAY, FEBRUARY 23, 1982

Good morning.

President Reagan's budget is a blueprint for growth and prosperity.

It is a plan for reducing Federal spending and the tax burden.

It is a plan for increasing the family budget.

For the first time, we are asking the right people to tighten their belts: the Federal government.

We have painstakingly gone through every item. All members of the Cabinet have met with the President on their programs. And we have fashioned a budget that responds to the President's call for a new Federalism; it meets the complex needs of our society; and it reduces the rate of growth in government.

This budget contains dramatic reductions in government spending, yet it's important for people to know that we are not tearing down the house or ransacking the furniture. We are simply trying to stop the runaway growth of past Federal spending and restore a measure of common sense to how we spend the people's money.

So let's take a quick look at how this budget was put together.

On the revenue side, we expect receipts totalling $666.1 billion for fiscal year 1983, of which $304.5 billion comes from individuals, $65.3 billion from corporations, $225.5 billion from payroll taxes and the remainder from excises, Federal Reserve earnings, and miscellaneous taxes and fees.

More importantly, we have in place a sound long-run tax system for the 1980's, one that will promote rapid growth of income, savings, investment and employment for years to come. That tax system, with a healthy economy, will generate as much revenue as government should reasonably be allowed to spend.

However, the revenue picture has been heavily affected by two factors: the recession and the drop in inflation -- one bitter pill and one piece of candy which together have signficantly decreased revenue to the point of causing large deficits. The recession is temporary, and the decline in inflation is most welcome.

We, therefore, had to face some tough decisions about how to cover the costs of some very important government programs -- how to make up the difference between the $666.1 billion in revenues and the $757.6 billion in outlays -- until the growing economy triggered by our reformed tax system brings growing revenues into line with restrained outlays.

Some have urged us to revoke the incentive-creating tax cuts already in place. The result would have been lower real growth for many years into the future. It would have involved a self-defeating major change in a permanent tax program to handle a temporary problem. That alternative was not seriously considered. Instead, we shall propose certain worthwhile tax reforms, upgrade our tax collection program, renew our efforts at controlling spending, and borrow to cover the remaining deficit.

Deficits are not good. They rob the private sector of financial and real resources needed for growth, and divert those resources into government consumption. So do taxes. The root of the problem is the Federal spending which appropriates those real resources and then must find the means to pay for them in one way or another.

The budget deficit can and must be narrowed from the spending side. For too long, spending has been rising faster than the economy has grown. The economy can no longer support the burden. Some progress was made last year in reducing the runaway rate of growth in Federal non-defense spending. Further efforts will be required this year and into the future.

Insofar as spending is not reduced, it is preferable to close the remaining transitional recession deficits of the sort now being experienced by borrowing rather than by taxing. The funds are pulled from the private sector in either case, but taxes impose a larger cost in terms of reduced incentives for real growth.

We must continue to strive to reduce the deficit by curtailing spending and promoting real growth. The budget and outlook we are proposing take major steps toward closing that deficit over the next several years. In the interim, it can be handled in a nondisruptive fashion. Let me put the deficit into perspective.

The projected deficits, though some of them are at record dollar levels, are not unusual following a recession when measured as a percent of GNP. The first attached chart shows deficits as a percent of GNP since 1975.

On- and off-budget deficits were 3.6 and 4.5 percent of GNP in Fiscal Years 1975 and 1976, due largely to the 1974-1975 recession. Deficits are projected to be 3.8 percent and 3.1 percent of GNP in Fiscal Years 1982 and 1983, largely as a result of the current recession. There has been considerable concern that our projected deficits will put extreme pressure on credit markets and thus drive up interest rates. However, deficits do not cause high interest rates. The historical record shows no direct association of deficits and interest rates; the second chart shows that in years with large deficits, interest rates went down more than they went up. Interest rates are determined by the real rate of return on capital, the expected inflation rate, and a premium for risk. Although deficits could conceivably influence expected inflation and risk, this would not happen, according to the latest Federal Reserve Board report, unless they were accompanied by excessive money creation.

As you all know, this administration has adopted a policy of slow and steady growth in the money supply. We are in agreement with the Federal Reserve Board's fight against inflation and support their announced intentions to reduce money growth rates gradually from year to year. Although we are concerned about the affect of the volatility in money growth on interest rates, we intend to work closely with the Fed in order to reduce these unhealthy fluctuations.

The deficits will be manageable because of the growth of private sector saving, as shown in the third chart.

Private saving resulting from normal year-over-year growth and the Economic Recovery Tax Act will be several times greater than the total borrowing requirement of the Federal government in 1983 and 1984 and thereafter.

The net additions to total private saving are larger than the rise in the deficit. They will produce "crowding in" rather than "crowding out." This extra shot in the arm of capital markets will put downward pressure on interest rates. Even after financing the Federal deficit, there will be billions of additional dollars each year for private investment.

Normal year-to-year increases in saving exceed $40 billion each year. This will be supplemented by the additional personal savings and additional business retained earning induced by the tax cuts.

Compared to 1981, private saving will be more than $60 billion higher in 1982, more than $170 billion higher in 1983, and more than $260 billion higher in 1984. Private saving was just under $480 billion in 1981. It will rise to more than $740 billion in 1984.

It has been lack of growth, more than anything else, that has been responsible for the current and projected deficit. As a rough rule of thumb, each time growth falls off by enough to produce a 1 percent increase in unemployment, the budget deficit widens by more than $25 billion. In fact, if we had grown fast enough over the past four years to get unemployment down below 6 percent, the current deficit would be roughly $75 billion lower.

Growth is the only way to balance the budget while promoting rising real income and employment. If the economy were growing at 4 to 5 percent per year in real terms, Federal revenues would be rising $30 to $35 billion per year in real terms, even under an indexed tax code without the windfall to the Federal government from bracket creep. That is how fast the deficit would be falling in 1982 dollars if real spending were being held constant. We have not asked for spending restraint of that magnitude, choosing a more gradual path toward budget balance. After a slight dip in real outlays in FY 1983, real outlays are projected to grow approximately one-third as fast as the economy in the following four years. However, we would be willing to look at further spending restraint if Congress wishes.

I would like to point out, very firmly, that any changes in the economic recovery program which reduce real growth will tend to worsen the budget picture. Changes which reduce individual or business saving by as much as or more than the deficit will only worsen the situation in the credit markets.

The budget is not merely an accounting document. One cannot simply take a billion dollars out of column A and put it in column B. There are behavior changes and economic repercussions from tax and spending shifts which affect saving, investment, labor supply, income and revenue. Very often, changes which may look good on paper will buy little or no progress toward solving a budget problem, especially compared to the economic cost to the whole nation of the policy shift.

These facts should be kept clearly in mind as we look at the deficits in this budget.

As President Reagan points out in his Budget Message, our success in reducing inflation has reduced tax receipts. Over the next five years, we project a steady fall in inflation. Yet if nominal GNP growth were just 2 percent higher each year, reflecting a continuation of higher inflation, Federal receipts would be enlarged by $353 billion over the five years as inflation and the progressive tax code pushed taxpayers into higher brackets. After allowing for inflated outlays, the budget deficit would be $38.5 billion lower in 1987.

In the past, this is how Administrations and Congresses planned to balance the budget. We have a better plan. We intend to balance the budget through spending restraint, lower taxes and higher real growth, not through inflation. In the short run, there will be substantial deficits, due primarily to the recession. However, we are confident that personal and business savings over the next few years will be adequate to finance both the projected deficits of the total government sector and a very rapid increase in real capital formation.

I realize that there has been concern over the apparent reluctance of business to plunge ahead with new investment. It is not suprising that some businessmen are holding back until they are certain it is safe to proceed. A lot of them are waiting for lower interest rates. Others are waiting to make certain that Congress will not make drastic changes in the Economic Recovery Tax Act so that they can plan with confidence. Nothing kills investment faster than uncertainty. Once these problems are resolved, the investment will be there.

RECEIPT PROPOSALS

While the Administration is opposed to increasing statutory tax rates -- rates which apply at the margin to taxpayers who work, save, and invest -- at the same time it is committed to insuring that the tax system is run efficiently and fairly. Thus, while we will not support increases in marginal rates for taxpayers, we do propose changes in three areas: 1) an elimination of abuses and obselete incentives within the system; 2) a major effort to improve tax collection and enforcement and 3) enterprise zone tax incentives and miscellaneous efforts to charge users of various Federal programs for the benefits they receive.

We want to eliminate abuses and to remove obsolete incentives within the system. In many cases, abuses arise because the use of special types of financial arrangements or legal devices allow one taxpayer to pay a much lower tax than a similar taxpayer engaged in exactly the same activity. Through the Accelerated Cost Recovery System (ACRS) and other provisions included in the Economic Recovery Tax Act of 1981, Congress, working with this Administration, has lowered effective marginal tax rate on all types of business activity. We do not, however, support haphazard and arbitrary reductions in average tax rates for specific groups of taxpayers.

Eliminating tax abuses is entirely consistent with the Administration's overall economic program. The abuses that we propose to eliminate generally do not provide desirable incentives. Even when they might affect marginal tax rates, the effect is so distorted and so difficult to disentangle from other effects that hardly any desirable incentive is provided. Indeed, when a tax provision provides benefits only to a business or individual with special financial and legal arrangements, rather than to all taxpayers engaging in a similar activity, then it may end up subsidizing less efficient taxpayers with competent counsel over more efficient ones who rely on less competent legal and financial advice.

This Administration proposes also that Congress join with it in improving tax collection and enforcement. Ensuring that taxes due the government are, in fact, paid by taxpayers and that they are paid on a timely basis is necessary to the maintenance of a fair and workable tax system. If nonpayment of taxes is allowed to go unchecked, it can slowly eat away at the well-being of our system that relies upon voluntary compliance. If individuals instead are convinced of the certainty yet fairness of enforcement efforts, and they know that no taxpayer will be given preference in paying tax as income is earned, then the system can work well. Taxpayers will comply honestly and support a system which they think is fairly administered. However, if the Government fails to make adequate efforts at enforcement and adopt proper methods of administration, then that support will erode.

Strengthened enforcement and improved tax collection are entirely consistent with the Administration's economic program. Improved compliance and timely payment of taxes owed does not raise statutory tax rates and has almost no effect on the rate of return from saving and investment, but it does reduce the opportunities and benefits from underreporting income.

Those who underpay their taxes indirectly raise the tax rates of those who report all of their income and pay their taxes on a timely basis. It would be foolish to argue that efficient productive incentives are provided by our maintaining a system in which it is easier for some persons to underreport income or to pay taxes later than others must.

While this Administration is committed to a program of improved tax collection and enforcement, we are not wedded only to the proposals presented in the budget. We look forward to Congressional input into this program and believe that your suggestions for improving collection and enforcement efforts will be vital to developing an overall bill. I feel confident that the resulting bill will be fair to the American people, yet at the same time will address in a forthright manner problems of compliance, administration and timely payment of taxes.

Finally, the Administration has proposed a number of initiatives to improve upon incentives in the economy, to insure that direct beneficiaries and users of various Governmental services are required to pay for some of these services, and to make more rational and consistent the operation of existing programs. While the initiatives involve many issues besides tax policy, I want to discuss them briefly with you today because they also have an effect on receipts.

Shortly we will be releasing comprehensive explanations of our proposals for major tax revisions and for improvements in tax collection and enforcement. We are also preparing legislative drafts which we will send up as soon as they are completed. However, let me now provide you with some brief details on each of our proposals.

TAX REVISIONS

Completed Contract Method of Accounting

Current regulations allow contractors to defer tax on income from long-term contracts until the year that the contract is completed. This completed contract method of tax accounting permits full deferral of income reporting on progress payments received by the contractor throughout the term of the contract even though certain costs are currently deducted.

The completed contract method thus permits income to be deferred for tax purposes long after payments are received and long after income is deemed earned according to standard accounting practices. The use of the completed contract method has led to large and unintended tax benefits. For instance, many contractors, including virtually all in the defense and aerospace industries, can substantially reduce their tax liability through the use of the completed contract method. This is accomplished by deferring all income from a contract until the contract is completed while taking allowable deductions for indirect costs currently. In some cases the period of deferral can be as long as 10, 15 or even 20 years.

Because of inflation and the increasing size of new contracts, deductible costs on new contracts often exceed income to be recognized from old contracts in any one year. The result has been that many taxpayers, while enjoying substantial economic profits and reporting these profits to shareholders and creditors, have been reporting large losses for tax purposes. These tax losses may shelter other income from taxation. In at least one case, the losses have been sufficient to eliminate the taxpayer's accumulated earnings and profits, enabling that taxpayer to make tax-free distributions to shareholders.

A particular problem resulting from the long-term contract accounting rules arises because certain construction contracts and contracts for the sale of heavy equipment include provisions for engineering or other assembly services to take place after delivery of parts and materials. Many taxpayers obtain additional deferral by maintaining that contracts are not complete until such services have been rendered. This is done even when full payment has been received upon delivery of parts and materials.

The Administration proposes legislation to disallow the use of the completed contract method of tax accounting, effective January 1, 1983. Taxpayers will be required to use either the percentage of completion method or the progress payment method of accounting for long-term contracts. The percentage of completion method permits current deductions for allowable costs but requires reporting income according to the percentage of the contract completed in the tax year. The progress payment method allocates costs to long-term contracts and defers their deduction until the taxpayer has a right to receive payment under the contract.

At the time the right to payment accrues, the taxpayer may deduct the total of the current and previously unclaimed costs allocated to a contract, up to the amount of the accrued payment. If the accrued payments exceed costs, the taxpayer would recognize such excess as income.

In addition, the Administration intends to amend the current completed contract regulations to require that most indirect costs (so-called period costs) be allocated to contracts rather than immediately expensed, and to clarify current rules regarding when contracts may be aggregated and when they must be severed in order to properly measure income.

The legislative and regulatory proposals would be effective for taxable years beginning after December 31, 1982. However, the legislative proposal provides that taxpayers may continue to use existing completed contract rules for contracts entered into on or before September 25, 1981, the date the Administration first announced its intention to change these rules. The regulatory proposal will similarly grandfather contracts entered into on or before September 25, 1981. Grandfathered contracts, however, may be affected by our corporate minimum tax as discussed below.

Repeal Business Energy Tax Credits

Under current law, businesses are allowed investment tax credits for energy property in addition to the regular investment tax credit. Also available are production tax credits and Industrial Development bond financing for certain energy sources. Current law further provides an excise tax exemption, or an equivalent tax credit, for gasohol. Some of these energy tax incentives expire at the end of 1982, but others extend through 1985 and beyond.

The original reasons for providing these tax incentives no longer apply today. At the time these incentives were proposed and enacted, price controls and allocations were in effect on both crude oil and natural gas, and there was substantial political resistance to decontrol. Prices of both oil and natural gas faced by consumers and received by producers were substantially below replacement costs, as reflected by the price of imported oil. Oil imports were growing at the same time that domestic consumption was being subsidized and domestic production discouraged.

Because of price controls, business firms and households had insufficient incentive to invest in energy-conserving capital or in alternative energy sources (other than oil or gas), or to use alternative fuels, such as fuels derived from alcohol, wood, or biomass. Therefore, some economic rationale may have existed for tax incentives for conservation and renewable energy.

Since enactment of the credits, however, crude oil prices have been decontrolled and partial decontrol of natural gas prices is being phased in. Whatever their original justification, the credits are no longer needed because most firms confront the true replacement cost of energy and therefore have sufficient incentive to invest in energy conservation and renewable energy and to purchase alternative fuels without targeted tax incentives.

The energy tax incentives distort the allocation of resources by encouraging firms to undertake investments that are uneconomic at current market prices and to purchase higher cost fuels when a lower cost substitute is available. As a result, these incentives divert workers, capital, and initiative from more productive uses elsewhere in the economy and lower the net productivity of the capital stock.

In general, tax incentives for specific investments fail to rely on markets to allocate resources efficiently. We believe that it is better to rely on the market, rather than Federal management, to determine patterns of energy use. The Administration's Accelerated Cost Recovery System (ACRS), enacted as part of the Economic Recovery Tax Act, has removed tax impediments to business investment -- including investments now eligible for energy tax incentives -- without dictating firms' choices among investment alternatives.

Moreover, by reducing the cost of only some conservation measures, the energy tax incentives discourage other, potentially more efficient, approaches. Many new inventions and refinements in old technology are not covered by the subsidies, and therefore are at a disadvantage because the Federal government subsidizes the competition.

Effective January 1, 1983, the Administration proposes to repeal all business energy tax credits, the gasahol excise tax exemption, and special provisions allowing States and localities to issue tax-exempt industrial development bonds to finance low-head hydroelectric facilities and other energy property. Fuel production credits and incentives for alcohol fuel production will also be repealed. Transition rules will mitigate the effect of repeal on taxpayers who have relied on existing law.

Restrict Tax-exempt Bonds for Private Activities

Current law permits States and localities to issue tax-exempt revenue bonds for industrial development, housing, and other private activities. There is no requirement under current law that industrial development bonds (IDBs) serve a genuine public purpose. In addition, tax-exempt financing, combined with Accelerated Cost Recovery and the investment tax credit, can result in unwarranted tax benefits.

The volume of private purpose tax-exempt bonds has grown rapidly. More than $25 billion were issued in 1981, up from $8.5 billion five years earlier. Private purpose bonds accounted for 24 percent of the tax-exempt bond market in 1976 but rose to 48 percent in 1981. The largest growth has occurred in small-issue IDBs, which allow tax-exempt financing for any trade or business. Small-issue IDBs marketed in 1981 reached an estimated $10.5 billion, out of the total $25 billion of private purpose bonds. Continued growth in the use of tax-exempt bonds for private purposes is expected unless actions are taken to limit their use. The expansion of tax-exempt bonds for private purposes affects the market for tax-exempt securities as a whole. This raises the cost to State and local governments of financing traditional public services.

Many of the private activities using tax-exempt financing would not have received direct Federal or local government assistance. Small-issue IDBs have been used to finance such private activities as office buildings for doctors and lawyers, fast food franchises, recreational facilities, and nursing homes operated for profit. Access to tax-exempt financing is offered in almost all political jurisdictions, either by State or local governments or by authorities acting on their behalf. These authorities are often established for the sole purpose of issuing tax-exempt revenue bonds for private entities and may serve to avoid local voter approval requirements.

Providing tax exemption for the interest on certain private purpose obligations may serve legitimate public purposes in some instances. Current law, however, does not require the showing of any genuine local public purpose. In fact, several issuing authorities have authorized tax-exempt bonds for facilities located outside of their own jurisdiction. A requirement that private purpose tax-exempt obligations be shown to serve the needs of the local community will improve the uses of the Federal tax benefit and will limit the volume of such obligations. This will reduce their impact on the market for traditional municipal bonds and the Federal government's revenue loss.

The availability of tax-exempt financing for exempt activities and other private purposes causes distortions in the allocation of capital resources. The ability to obtain a lower cost of borrowing for certain activities creates a bias in favor of investment in those activities. In effect, those favored activities are subsidized at the expense of other activities. Thus, the allocation of capital is based upon government decisions rather than upon its relative economic productivity.

Moreover, in combination with the accelerated cost recovery provided investment by the Economic Recovery Tax Act, tax-exempt financing results in unwarranted subsidy for many eligible borrowers. This combination of tax benefits completely eliminates the tax on income from certain investments and also provides tax shelter for income from other assets. "Double dipping" of this sort should not be allowed.

In contrast with other categories of private purpose tax-exempt bonds, exempt small issues may be used in limited dollar amounts for any type of investment in depreciable property or land. Large businesses presently are able to finance an unlimited number of facilities with small-issue IDB's because the dollar limits apply only within a single city or county. For example, one of the largest chains of retail stores in the country, has financed facilities in at least 100 localities, to the tune of $240 million since 1976. Many large firms are using small-issue IDB's even though they are able to raise funds readily in capital markets without a government subsidy or guarantee.

The Administration proposes that assets financed with tax-exempt bonds issued after 1982 must be depreciated using the straight-line method over extended recovery periods. In addition, the tax exemption for private purpose bonds will be limited to those that are publicly approved by State or local governments and which, for bonds issued after 1985, receive a financial contribution or commitment from the local government. Small issue industrial development bonds will not be allowed for large businesses, which have capital expenditures exceeding $20 million over a six-year period. Additional requirements relating to information reporting of IDBs, registration, and arbitrage profits also will be imposed.

Modified Coinsurance

Many insurance companies have entered into modified coinsurance arrangements and have claimed substantial reductions in their tax liability. Such arrangements are designed principally for tax avoidance since little, if any, insurance risk is actually transferred between companies.

In form, modified coinsurance agreements involve the transfer of insurance risk between two companies. In substance, virtually no insurance risk is actually transferred. Although together they may be in the same financial and risk position after the transfer, their combined taxes are lowered substantially. Many policies reinsured under modified coinsurance involve little, if any, present insurance risk. Because there is no meaningful transfer of risk, there is generally no significant non-tax business purposes for most modified coinsurance agreements.

Modified coinsurance agrements are structured so that actual payment between the companies is a small percentage of the amount of income converted. This small charge represents the "coinsurer's" fee for entering into the agreement. The nominal amount charged indicates the absence of any significant transfer of risk or economic purpose under the modified coinsurance agreement.

The modified coinsurance provision of the Code was never intended to produce large tax benefits for insurance companies. The federal corporate income paid by the largest mutual life insurance companies fell by 35 percent from 1979 to 1980, and by more than 40 percent from 1980 to 1981. The primary reason for this reduction is modified coinsurance. In several cases, the effect was to nearly eliminate tax liability.

Through regulations and legislation the Administration proposes to eliminate the unintended tax benefits resulting from the use of modified coinsurance. In addition, the tax treatment of other forms of coinsurance will be changed to prevent insurance companies from obtaining similar unintended tax benefits. The legislative proposal applies to all reinsurance agreements entered into after December 31, 1981.

Capitalization of Construction Period Interest and Taxes

Individual taxpayers must capitalize interest and taxes incurred during the construction of commercial and industrial buildings and deduct those costs over ten years. Under provisions of the Tax Reform Act of 1976, the write-off period for rental housing (other than low-income housing) is 8 years, but is scheduled to become 10 years by 1984. However, for corporations (other than subchapter S corporations and personal holding companies), the law permits immediate write-off of these costs. The substantial acceleration of cost recovery provided by the Economic Recovery Tax Act of 1981 makes it unnecessary to grant corporations an immediate deduction for a portion of construction costs.

It is a well-established financial and tax accounting principle that the costs of acquiring an asset, whether it is held for resale or for use in the production of goods and services for future sale, should be considered a capital cost, not a current cost, of earning income. Only when the asset itself is sold may the capitalized cost be recovered as a deduction from the sales proceeds in determining gain; or, if the asset is used by the owner to produce goods and services for sale, the capitalized cost may be recovered as deductions over a reasonable period as the asset is used.

Unlike most corporate taxpayers, individuals and partnerships are required to capitalize construction period interest and taxes other than those associated with low-income housing. These costs of acquiring assets are like other construction costs such as labor, materials, fees, and permits, all of which are capitalized and recovered when the real estate is sold or used to produce income. There is no economic policy or tax administration reason why corporations should not be subject to the same rules as individual taxpayers who construct commercial and other nonresidential buildings. Indeed, it is both economically inefficient and unfair to apply different sets of accounting rules to taxpayers according to their form of organization.

The Administration proposes that construction period interest and taxes incurred by corporations to develop non-residential real property after December 31, 1982 be capitalized. Costs will be recovered over 10 years. This proposal will not change the tax treatment of residential construction. The cost of commercial construction undertaken by corporations will be increased by a small amount, normally less than 2 percent.

Corporate Minimum Tax

Corporations currently must pay a minimum tax, in addition to regular income tax, equal to 15 percent of certain tax preferences. This "add-on" minimum tax is not limited to those corporations that pay very little or no regular income tax. It may apply to any corporation that has reduced its tax liability through the use of designated tax preferences.

Nonetheless, many corporations currently pay no Federal corporation income tax, despite reporting large profits to their shareholders. The proposed corporate minimum tax would tax "corporate profits," that is, regular taxable income plus certain special deductions, and would apply only to those corporations that pay very low regular rates of tax.

For corporations other than Subchapter S corporations and personal holding companies, the Administration proposes to repeal the add-on minimum tax, effective January 1, 1983, and to replace it with an alternative minimum tax. Corporations will be required to pay the greater of their regular income tax or an alternative tax equal to 15 percent of their alternative tax base. This alternative tax base equals regular taxable income plus certain tax preferences, less $50,000. The alternative tax base will include both preferences from the current minimum tax and a number of new preference items. Current preference items also in the alternative base are:

- Percentage depletion in excess of the year-end adjusted basis of the property,
- Accelerated depreciation on real property in excess of that allowable under the 15-year straight-line method,
- Amortization of certified pollution control facilities, and child care in excess of normally allowable depreciation, and
- Reserves for losses on bad debts of financial institutions in excess of reserves allowable on the basis of their experience.

The alternative base will also include the following new preference items:

- Intangible drilling costs in excess of amounts allowable had they been amortized over 10 years,
- Mining exploration and development costs in excess of those allowable under a 10-year amortization schedule,

- Lessor's leasing benefits which are in excess of net cash investment amortized on the straight-line basis over the term of a safe-harbor lease,

- Deductions for interest on debt to carry tax-exempt securities,

- Deferred DISC income,

- Shipping income deposited in capital construction funds or construction reserve funds,

- Amortization of motor carrier operating rights deductible under Section 266 of the Economic Recovery Tax Act of 1981,

- Original issue discount interest deductions in excess of amounts that would be deductible under a constant interest rate bond, and

- Current deductions of certain indirect costs incurred with respect to long-term contracts entered into before September 25, 1981.

The foreign tax credit is the only existing credit claimable against the alternative minimum tax. Investment tax credits which give no benefit due to the minimum tax can be carried forward.

We look forward to working with this Committee to develop a base for the corporate minimum tax that is reasonable and fair, yet insures that all profitable corporations pay their share of tax.

IMPROVED TAX COLLECTION AND ENFORCEMENT

Withholding on Interest and Dividends

Individuals who honestly report their interest and dividends pay more than their fair share of the total tax burden. Recovering known lost tax revenues by withholding -- where a reporting system is already largely in place -- is both an efficient and a sensible step to take.

Imposition of withholding on interest and dividends is a natural complement to the Economic Recovery Tax Act objective of reducing the tax burden on income from investment. Withholding offers an opportunity to increase tax revenues substantially without raising taxes on those citizens who carry their full share of the tax burden of this country.

While individuals are estimated to underreport wage income by only 2 to 3 percent, the comparable figure for interest and dividend income is 9 to 16 percent. Even with the additional reporting requirements enacted in the Revenue Act of 1962, a number of taxpayers still fail to report and pay tax on around $20 billion of taxable dividends and interest.

As interest and dividends have increased as a share of individual incomes, the compliance problems of underreporting has also increased. In 1962, interest and dividends represented approximately 5.3 percent of adjusted gross income; by 1981, interest and dividends represented 8.4 percent of reported adjusted gross income -- an increase from $40 billion to $150 billion. At the same time, the portion of individuals' income represented by wages declined by at least an equivalent amount. As a result of this change in the composition of the Nation's income, taxpayer compliance overall has declined because a smaller portion of overall income is subject to withholding.

Unfortunately, information reporting is simply inadequate to reduce this shortfall. Much of the unreported interest and dividend income consists of relatively small amounts that millions of taxpayers simply neglect to report -- as a result of failure to maintain records, or other causes not amounting to fraud. Although the IRS matches a high proportion of the information returns filed, there are a number of reasons why the matching process cannot close the gap of unreported income. Many information returns contain inadequate or inaccurate information, with the result that matching is difficult or impossible. In the wage area, by contrast, the number of unprocessable information returns is much lower because taxpayers have an incentive to obtain proper credit for withheld taxes. It is extremely expensive for the IRS to use letters, phone calls, and personal visits to follow up taxpayers suspected of underreporting, especially when only small amounts of tax may be collected from each one.

The obvious failure of some taxpayers to report interest and dividend income diminishes public respect for the tax system, and jeopardizes our system of voluntary compliance. Moreover, past experience has proven that withholding is by far the most effective means of combatting noncompliance in the reporting of income.

Under the proposal, 5 percent of payments of taxable interest and dividends would be withheld. Nontaxable individuals filing exemption certificates and corporations would be exempt from withholding. Taxpayers aged 65 or older with a tax liability of $500 ($1,000 on a joint return) or less would also be exempt from withholding. This will exempt elderly couples earning less than $14,907 in 1983.

This withholding proposal differs significantly from past withholding proposals. The problem of forced overwithholding, so prevalent in those past proposals, has been virtually eliminated by the low rate of withholding, the proposed exemption procedures, and the provision in ERTA which will allow workers to adjust wage withholding for any overwithholding that could occur. In addition, we must recognize that the system of reporting of interest and dividend income on forms 1099 is well established; new forms will be quite similar to the old forms, with an additional line for the amount of tax withheld. Costs to financial institutions thereby will be kept to a minimum. Indeed, my own experience as head of a large financial organization, along with many discussions with officers of our Nation's financial institutions, has convinced me that withholding is a sound and efficient means of increasing compliance.

Corporate Income Tax Payment Speedup

Corporations generally are required to pay at least 80 percent of their current year's tax liability in estimated payments due four times a year. The remaining liability is payable in two equal installments due on the 15th day of the 3rd and 6th months following the close of their taxable year. An exception to the estimated tax payments rules permits corporations to base their estimated tax payments on the full amount of their prior year's tax liability. For large corporations, the estimated payments must be at least 65 percent of their current year's liability (75 percent in 1983 and 80 percent thereafter).

To the extent feasible, taxes should be paid on a current basis. Given the ability of corporations to estimate their income on a monthly basis, there is no longer any reason to permit corporations to underpay their taxes by up to 20 percent. A 10 percent deviation is sufficient to reflect the uncertainties of intra-year estimates.

In order to collect corporate taxes on a more current basis, the Administration proposes, for tax years beginning after 1982, to increase the required estimated tax payment from 80 percent to 90 percent of the current year's liability, and to require that all remaining liability be paid in one payment on the 15th day of the 3rd month following the close of the tax year. In addition, large corporations making estimated tax payments based on prior year's liability will be required to pay at least 85 percent of their current year's liability in 1985 and 90 percent thereafter. All corporations with taxable incomes of less than $1 million in each of the three prior years will be exempt from this latter rule.

IRS Staff Increases

In order to improve the efficiency of enforcement and collection activities, the Administration proposes to increase the enforcement staff of the Internal Revenue Service by more than 5,000 persons.

Three thousand of these 5,000 new employees will be assigned to collecting delinquent taxes, 1,000 will concentrate on the identification of nonfilers who owe tax, and the remaining 1,000 will examine deficient returns and process appeals.

Although the vast majority of taxpayers voluntarily pay their correct tax on time, delinquent taxpayers currently owe the Treasury more than $20 billion in uncollected taxes. An estimated additional $70 billion in revenues are lost each year as a result of unreported income and improper deductions. A strengthening of Internal Revenue Service enforcement activities will generate increased government revenue and will improve the fairness of the tax system for all taxpayers. Public confidence in the equity of our tax laws is preserved only if the few who fail to pay their fair share are held accountable.

OTHER PROPOSALS AFFECTING RECEIPTS

Enterprise Zone Tax Incentives

Under current law, no special tax incentives are provided for the redevelopment of depressed areas. The Administration therefore proposes that beginning January 1, 1984, up to 25 small urban areas per year (not to exceed 75 in total) may be designated as "enterprise zones". Relief from Federal, State or local regulations, and special tax incentives designed to increase investment and employment will be provided businesses and individuals locating in these areas. These incentives will be applicable for a 20-year period. The Administration will be providing you with details on this proposal at a later date.

Miscellaneous Proposals

- Airport and airway trust fund taxes. Statutory authority for the airport and airway trust fund expired on September 30, 1980. The Administration proposes to reinstate statutory authority for the airport and airway trust fund effective July 1, 1982.
- Increases in passport and visa fees. The Administration has proposed an increase in passport fees from $15 to $30 effective April 1, 1982, and an

increase in immigrant visa fees from $25 to $100 effective March 1, 1982.

- Change in railroad retirement system. The railroad retirement system provides coverage generally equivalent to a combination of social security and a multi-employer industry pension plan. Railroad employees and employers make contributions to railroad retirement that are generally equivalent to social security payroll taxes. Beginning October 1, 1982, the Administration proposes to extend full social security coverage to railroad workers; payroll taxes would be deposited directly in the social security trust funds. The Administration also proposes to return the rail industry's plan to the private sector.

- Extension of highway trust fund taxes. Under current law, the 4 cents per gallon tax on gasoline and diesel fuels will decline to 1.5 cents per gallon on October 1, 1984. Several other taxes that are deposited in the highway trust fund will be reduced or will expire at the same time. The Administration proposes to extend these taxes at their present rate.

- Extension of social security hospital insurance taxes to Federal employees. Most Federal civilian employees currently are exempt from social security taxes. The Administration proposes to require Federal employees to pay the employee portion of the social security hospital insurance tax effective January 1, 1983.

Technical Proposals

As soon as possible technical proposals will be submitted to further close tax loopholes and facilitate IRS collection and enforcement efforts.

CONCLUSION

We have in place a tax system for the 1980's that will promote the growth of income, savings, investment and employment for years to come. Eliminating the incentives just adopted by Congress and choosing instead to steadily increase tax rates would only be a return to the policies of the past -- policies that have been tried and failed.

The budget deficits can and must be narrowed, but from the spending side, not the tax side. While the recession will cause substantial deficits in the short run, it is only higher real growth in the long run that will restore our

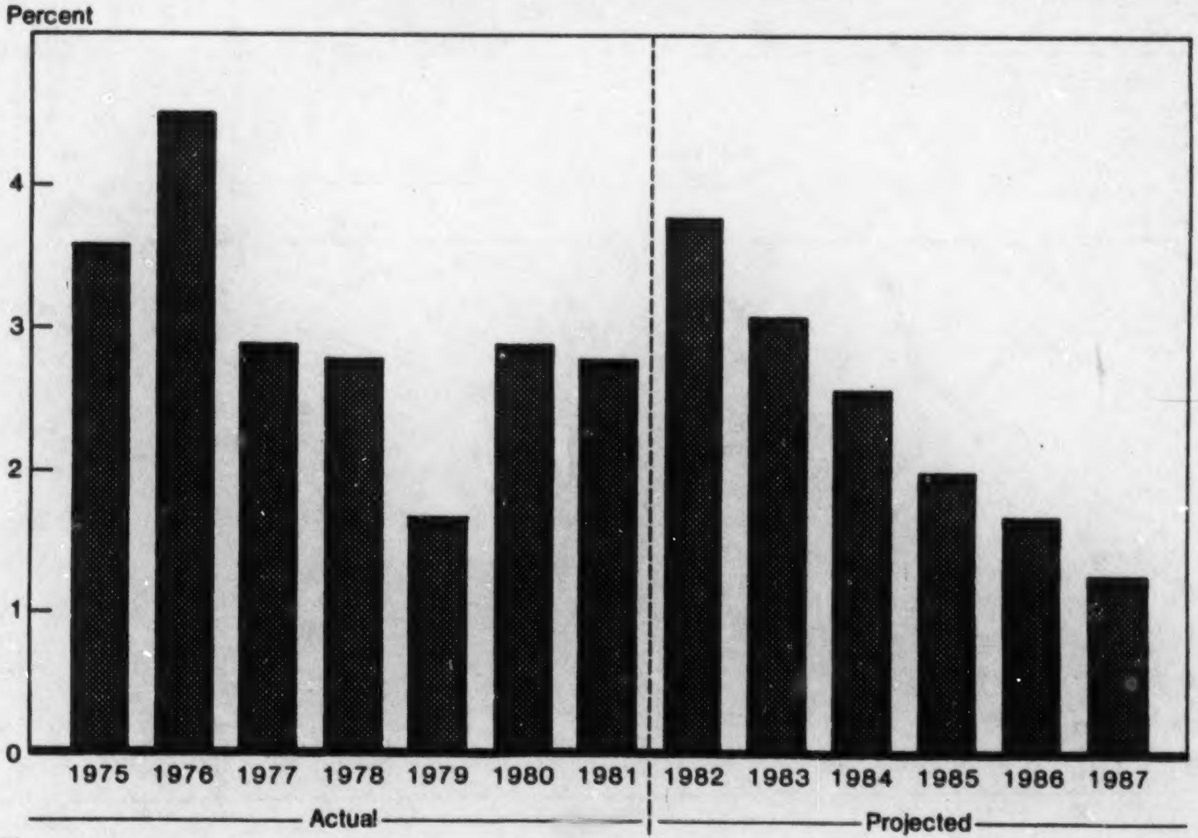
Nation's health. Raising tax rates will only exacerbate our problems by lowering possible future growth.

While the Administration is opposed to raising tax rates in general, it recognizes the need to insure that the tax system is run efficiently and fairly. We support a program to eliminate abuses and eliminate obsolete incentives, to make major improvements in tax collection and enforcement, to create enterprise zone tax incentives and to make efforts to charge users of various Federal programs for the benefits that they receive.

Let me throw out a final challenge to those who might oppose the Administration's tax program. I recognize that there are those who did not and do not support reductions in rates of tax for individuals and businesses, and I recognize that there are those who will oppose the initiatives that we have presented to you today. What I find most incomprehensible, however, are those persons who can oppose both. At least in part, these individuals can only be proposing that an increase in tax rates on all taxpayers is a better means of raising revenues than eliminating abuses and obsolete incentives, or improving compliance and enforcement programs. This type of choice, however, favors "special interests", those who are able to engage in complex financial and legal arrangements, those who underreport their income, those who do not pay taxes on a timely basis and users of services who do not pay for the benefits that they receive. Such favoritism is not warranted for two reasons: first, it is blatantly unfair to the taxpayer who willingly and honestly pays his fair share of the tax burden, and, second, as a substitute for direct rate reductions, it provides much less incentive for restoring our Nation's economic health.

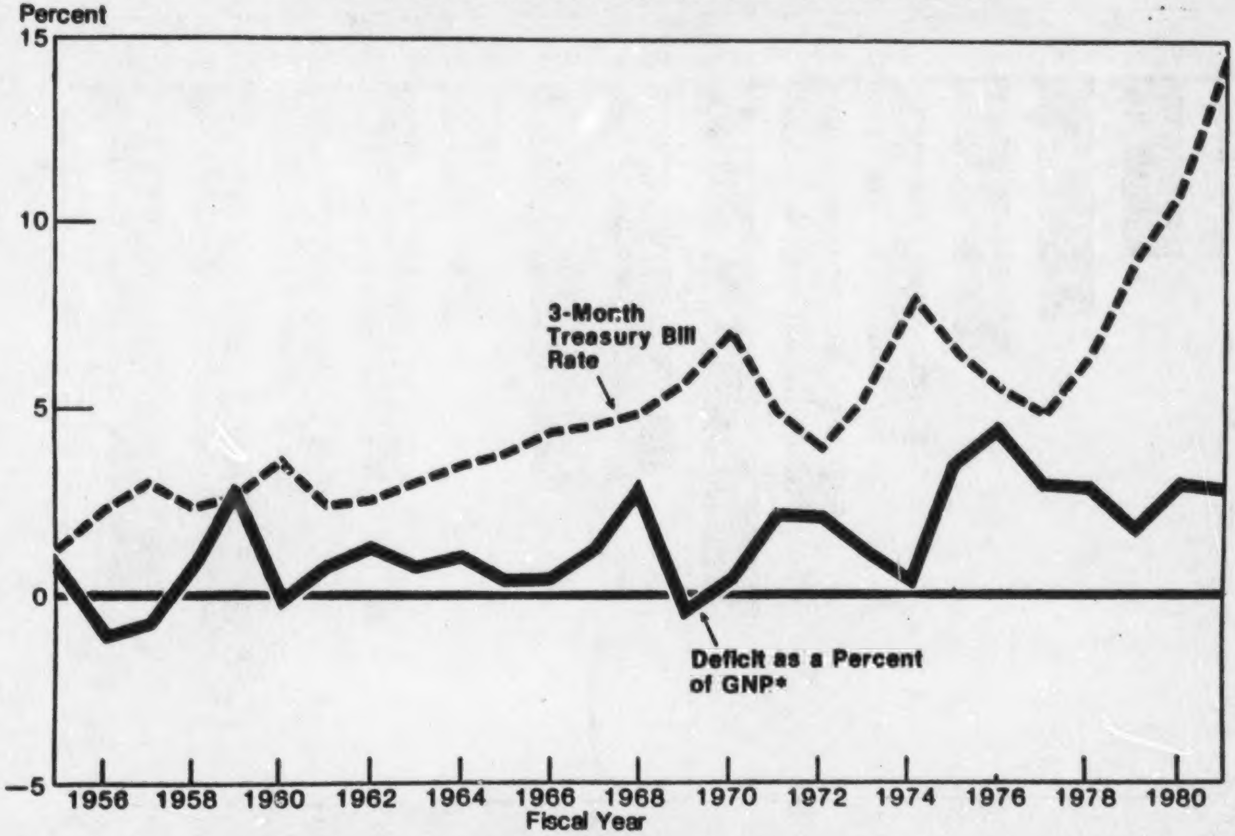
Mr. Chairman, I do not believe that most members of this Committee will favor special interests over the average taxpayer. I invite each member of this Committee to work with us on the proposals that I have outlined for you. Indeed, I look forward to your suggestions for ways to strengthen our efforts to eliminate abuses and obsolete incentives, to improve compliance and enforcement, to create enterprise zone incentives and to charge users of various Federal programs for the benefits that they receive.

Budget Deficits in Relation to GNP*



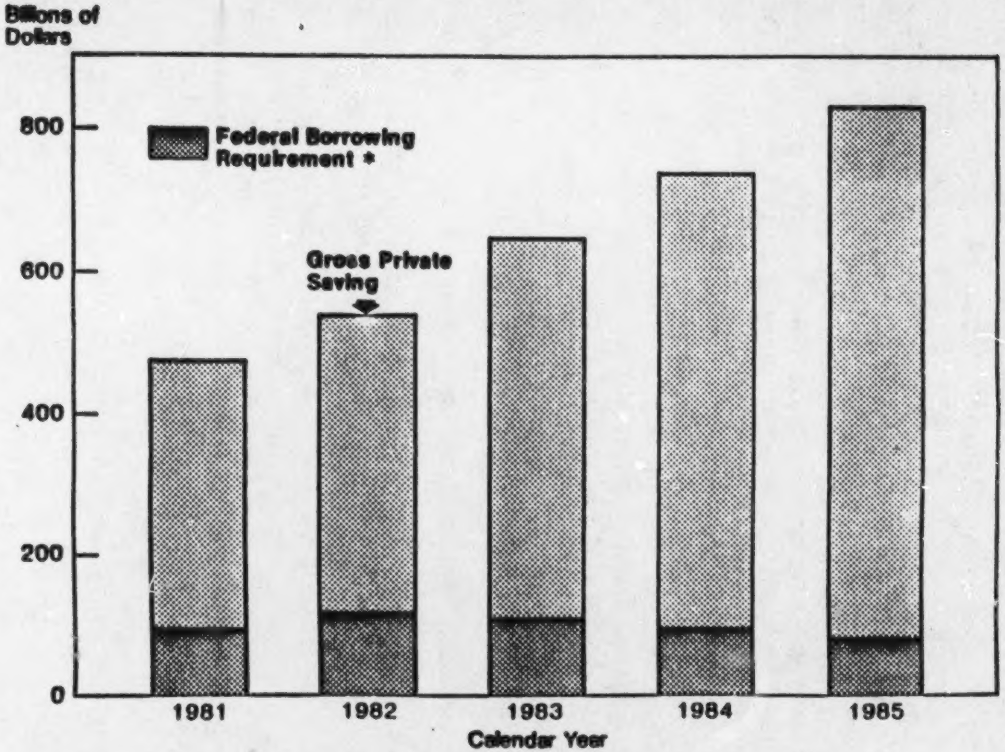
* On and off budget as percent of fiscal year GNP.

Interest Rates and the Relative Size of the Deficit



* Federal surplus or deficit includes off-budget items. Points below zero line represent surplus as percent of GNP, points above line a deficit.

Projected Borrowing Requirement in Relation to Private Saving



* Total calendar year budget deficit including off-budget entities.

Note: Saving flows do not reflect surpluses of state and local governments or inflows from abroad.

The CHAIRMAN. We will operate under the so-called early-bird rule, and maybe 7 minutes the first round. If any other members have pressing other committees, we would be happy to accommodate anybody who must be somewhere else in the next few minutes. So if you would just let us know, we could take care of that.

Last fall, Mr. Secretary, you testified before the Budget Committee that the economy would turn up this spring. Lately, it would appear from the President's press conference and other indications, that that date is being pushed back. Can you give me any idea of when we might expect the recession to end? I don't expect a specific date or week or maybe even a month, but is it still spring?

Secretary REGAN. I think the second quarter of calendar 1982, Mr. Chairman, is when we will see a positive return in real growth of GNP. I don't think that the administration is waffling from that earlier projection. I think what the President was saying in his press conference last week was exactly what you just said: He didn't want to be pinned down to a specific date or a specific month. But I am confident, having talked to him, that he shares our view that in the second quarter will return to real growth in GNP.

The CHAIRMAN. Following up on that, can I assume, then, that you are fairly optimistic?

Secretary REGAN. As usual, Mr. Chairman, I am a bit bullish.

The CHAIRMAN. Are you more or less optimistic than you were when you were here before?

Secretary REGAN. Strangely enough, I am more optimistic. Maybe I am whistling in the dark here; maybe I see things that others don't see; but I do think that we will snap back from the current recession and do it this year.

The CHAIRMAN. Yesterday the 90-day Treasury bill rates fell by more than 2 percentage points. Does this signal the long-expected break in the interest rates?

Secretary REGAN. Well, it's, I would say, at least one swallow, which of course is much better than a turkey. I've noticed that several of the large banks have dropped their prime back to 16½ this morning. So I suggest that we seem to be getting some break.

But notice what happened here. In spite of the talk about our big deficits, and the like, what really has happened is people watch the change in the money supply, and there was a dramatic drop in the money supply announced unexpectedly—well, the announcement was expected, but the size of the drop was not expected. It was $3½ billion last Friday. As a result of that, the markets took heart that the Fed might not have to tighten up as much as they had expected.

The CHAIRMAN. It's my understanding the policy of the administration and Fed is one of cooperation now; is that correct characterization?

Secretary REGAN. We support their goals, announced monetary goals, for this year.

The CHAIRMAN. And it has been suggested by, I think, Senator Jepsen and Congressman Reuss that we adjust the withholding tables now to reflect a 10-percent tax cut scheduled in July. I think Treasury has been looking at that proposal. That would differ with other proposals which would take it back to January, the full 10 percent, which would be very costly. Have you given any indication to anyone whether or not that is feasible or whether you would support such a move? Maybe just reflect the change of withholding tables in April or May, or at the earliest possible time?

Secretary REGAN. Well, we have taken a look at that. And from the point of view of actually trying to get it through the Congress, signed by the President, and then have IRS come up with new tables, publish them and have that go into effect, it would be probably well into May if not into June before all of that could be accomplished.

You would know better than I, Mr. Chairman, the difficulty of getting such a thing through the Congress quickly, and you would have to get it through the Congress within 30 or 45 days in order to give the IRS, well, what? Three to five weeks—maybe they could shorten that—to change the tables and have them go into effect. So I don't think it's a practical suggestion at this particular time. I think we should leave well enough alone and go ahead with the July 1, 1982, cut.

The CHAIRMAN. As I understand, at least from published reports, you do not support a trial balloon that was quoted by the majority leader on the surtax. Is that correct? I am not certain I do, either, but I would get your views first.

Secretary REGAN. Well, I think what has happened here on the surtax, I think that is the type of suggestion that we will be seeing coming from the Congress over the next several weeks and months as you wrestle with the same problems that we in the administration were wrestling with in November, December, and January. We finally came to the conclusion that the tax increases were not feasible except for certain changes in the Tax Code, and I've just summarized those suggestions to you. We came up with certain budgetary suggestions. We went as far as we thought we could, and we decided to live with the big deficits.

Now, it may be that the Congress will differ in their views, but I think at this time I would rather not comment on all of these individually as they come up, lest each day I be required to comment as someone else has a new suggestion. I would rather wait and see how the Congress finally comes out.

I do want to say this about surtaxes, though: This was tried during the Johnson administration. They did manage to have a surplus in 1 year, but then fell right off the wagon again, and we went into even worse deficits immediately thereafter. So, at best, that's a temporary palliative.

The CHAIRMAN. I think my time has about expired. But as I understand all of these suggestions you have made, you would hope that we might make those effective in January of 1983?

Secretary REGAN. Yes. Our effective date for all of this is January 1, 1983. Nothing is suggested for the immediate future.

The CHAIRMAN. There is some rumor that the insurance provision, that they think they ought to postpone that and not even consider it until calendar year 1983, and that was not my impression.

Secretary REGAN. We would want that considered this year, passed this year, and made effective January 1, of 1983.

The CHAIRMAN. We were told by the insurance industry last year that if we didn't do anything last year, our so-called second tax bill, they would be ready to go this year. Now they say they are ready to go next year. I assume next year they would be ready to go the next year.

Secretary REGAN. I would assume so, Mr. Chairman.

The CHAIRMAN. Senator Bentsen?

Senator BENTSEN. Thank you very much, Mr. Chairman.

Mr. Secretary, I have just returned from the State of Texas, and I have never seen such apprehension on the part of the people of my State concerning high interest rates and the deficit we are facing.

Yet, at the same time we are facing a record deficit, we have a number of highly unfair tax breaks that drain large sums from the Treasury. One of the provisions that is most unfair is the sale of tax credits to very profitable corporations—which can result in their avoiding taxes completely. I have talked to members of boards of directors of companies that are buying tax credits and they say, "The law is there. We are going to take advantage of it. But we don't understand why it's put in there." It seems to me that's an obvious place to try to cut back on the administration's deficit. I have been told that there are over $3 to $4 billion worth of such tax credits sales already under negotiation for this year.

Mr. Secretary, allowing the very profitable of this country to pay no taxes at all, not only adds substantially to the deficit, but also destroys confidence in the tax system. That is wrong and ought to be done away with.

I introduced an amendment to try to strike those provisions from the 1981 tax bill, but at that time very few people understood the problems inherent in the sale of tax credits, so I didn't get much support for my amendment. But I understand there are now over 20 of those bills introduced to do just that.

I would like your reaction to a possible repeal of that provision, as well as to the possibility of establishing an effective minimum tax on corporations.

I fully support tax breaks that will actually increase productivity.

I worked very hard to increase depreciation and accelerate it so corporations could buy new equipment and new plants to make us more productive; but productivity won't increase by allowing major corporations to buy tax losses.

Secretary REGAN. Well, let's take a look at some of the history of this, Senator, and see if we can come up with some additional thoughts on it.

First of all, you will recall that the administration proposed this last year at a time when people were talking about refundable tax credits, because there are many industries in the United States, unfortunately, that cannot use their tax credits—the steel industry, the automobile industry, the airline industry to some extent, obviously the construction industry. They cannot use their investment tax credits, yet the Congress and the administration wanted to see what they could do to help those industries, particularly even more so now that we are in a recession and these are the industries where we have the highest rates of unemployment.

Senator BENTSEN. Well, Mr. Secretary, wouldn't directly refunding those companies with excess tax credits be more equitable than the present approach, which allows profitable corporations to pay no tax?

Secretary **Regan**. Well, to the extent, though, that we are getting at that through the minimum tax, that leasing will be part of the preferences that will go into the minimum tax.

Senator **Bentsen**. Well, let me comment on that. You made a comment that one of the reasons that business was not investing was because they were concerned that Congress might pass a drastic take back of these provisions. Yet, that charge is better laid at the doorstep of the administration.

The tax reductions of last year's bill for 1982 to 1985 were $77 billion. The administration now proposes to take back $40.2 billion or 52.1 percent of what the corporations got out of the tax bill. That's what your own numbers say that you are proposing. It seems to me that it's the administration talking about a major change.

Secretary **Regan**. Well, again, come back to what we are trying to do here. There are certain segments of American business which have been, we think, unduly favored by the Tax Code. And as a result, they have come up with strange interpretations of the Tax Code which I don't think were the intention of the Congress in passing it. Modified co-insurance is certainly an example of that. That started in 1978–79 and has grown so much so now that our tax collections from insurance companies are less than 40 percent of what they were.

Senator **Bentsen**. Mr. Secretary, obviously changes are going to have to be made in that provision. But there is a very specific abuse taking place in the sale of tax credits that must be addressed.

Secretary **Regan**. Well, Senator, I would ask that you withhold comment until such time as we can get the whole study to you. As you know, the IRS was asked to have anyone engaging in leasing report to it by January 31 of the type of lease and the details of it. We now have that information in place. We are rushing with highest priority in the IRS to try to come out with that study. We hope to have it by mid-March. And then, over a period of the next 30 or 60 days we can analyze it together to see exactly what did happen.

Senator **Bentsen**. All right. I will look forward to reading your study, but you are going to see a lot of people rushing through that loophole in the meantime.

I would like to also comment on the housing situation. I recall last year you were saying that the depression in housing would end shortly because lower interest rates were coming and because there would be a general recovery in the economy. Of course, we have not seen that yet. Yet, you are targeting further cuts in Ginnie Mae and for the elimination of it by 1984, a drastic 70 percent cut in farmers home loans, and cutbacks in Federal assistance for elderly and handicapped housing. The result of those proposals will only accelerate the problem.

We are looking at a situation in the Farmers Home Administration where delinquencies have increased by 35 percent. We are seeing an increase in bankruptcies and unemployment and the home building industry. Now the administration wants to gut a program that has been underway for 45 years and that has been a successful one. It seems to me that this is a contradictory course, and I don't really see it as a budget-saving item.

Secretary **Regan**. Well, what we have done is to try to cut back on the size of those programs. They have grown enormously in the last 4 or 5 years. There is still a very healthy amount of mortgage money available through those programs. We haven't cut it off entirely. It is high rates of interest more than the size or the amount of what we are suggesting that will determine when and how the housing industry gets started again. I think, personally, that if interest rates, the prime in particular, were down to where construction loans could be carried below 14 percent, I think you would see a real revival in housing starting. Hopefully that will occur this spring.

Senator **Bentsen**. Well, Mr. Secretary, you know how people buy a home: they don't pay attention to the average price so much, they look at the monthly payment and then see if they can work that into their budget. Right now, they find they just can't do it. So a lot of these young people that were going to be moving out on their own are still staying in the nest with mom and pop.

I remember when I got back from World War II we had something called the GI bill that helped me buy a home. But today the only GI provision that works is "Generous In-laws." [Laughter.]

If you don't have that, you just can't buy a home. The American dream of homeownership is disappearing, and the administration should be concerned about that.

Secretary **Regan**. I know, Senator. The most recent figures indicate that in many cases home ownership is taking as much as 40 percent of income available to families, where it traditionally used to be something in the neighborhood of 25 percent. That is entirely due to high interest rates.

However, I do think that the whole question here is: How fast can we get interest rates down? I think that is the final answer.

Senator **Bentsen**. Thank you.

The **Chairman**. Senator Byrd, then Senator Heinz.

Senator **Byrd**. Thank you, Mr. Chairman.

Mr. Secretary, in your statement you asked for the cooperation of the members of the committee. I want to offer my cooperation. I supported Ronald Reagan for President, and I've long been an admirer of yours. So I want to cooperate in every way possible.

In your statement you say the budget deficit can and must be narrowed from the spending side, and I certainly agree with that. I think the problem in Washington now is, and has been for so long, excessive spending. So I support the spending cuts, which indeed are not cuts at all but rather a reduction in the rate of increase in spending. I support the Reagan spending restraints and would go further and support a restraint on the tremendous increase in military spending, because I think we are in a very severe situation economically in this country.

Now, in your statement you say we intend to balance the budget. My question is: When?

Secretary **Regan**. Well, Senator, I would say that we are hopeful that in the out-years this will come about.

More important even than balancing the budget, an actual true balance, is the direction that we are going toward. I think that is what the money markets and other people are looking at. If we can keep getting the share of Gross National Product that the Federal Government takes on a downward slope, I think that's even more imperative than actual coming to zero at any particular time.

Senator BYRD. But your statement says we intend to balance the budget. And all I am asking is, is when?

Secretary REGAN. Well, it's hard to be precise, sir, because as you go out, as the President himself said in his remarks in the State of the Union message, the figures that we give for 1986 and 87, 4 and 5 years out from now, are so imprecise that we cannot be sure what would happen.

Let me give you an example. Were we to return to let's say a 5- or 6-percent rate of unemployment, that budget deficit would be reduced by about $50 to $75 billion. Were Gross National Product real growth rate to be 1 percent higher, there would be a swing of another 20 or 25 billion. And these projections are so imprecise out there that it's hard to be exact—and I'm not trying to dissemble, Senator, I'm just saying it's very hard to be precise when you get out 4 and 5 years as to exactly where we are going to be. But we are hopeful that in that time period we can bring it about.

Senator BYRD. Many feel, as do I, that the projected deficits, which will approach or exceed $100 billion for 3 years, at least 3 years, and that these deficits are alarming and dangerous. Would you give me your view?

Secretary REGAN. Yes. Deficits are not good for anyone. They cause a great deal of uncertainty in the money markets. It means that the Federal Government is taking funds, either by borrowing or by taxes, out of the economy that could otherwise be spent in the private sector, and in my opinion in a better fashion than we spend it in government. So deficits are bad, and it's part of the reason, in answer to what Senator Roth said earlier, that we have this huge gap, the uncertainty gap, the premium that we are being made to pay over and above the real rates plus the rate of inflation.

Senator BYRD. Interest rates certainly are devastating, and I personally don't see how we can stimulate the housing market or the automobile market, the two major segments of our economy, until interest rates are brought down. Can interest rates be brought down with deficits approaching $100 billion for 3 years in a row?

Secretary REGAN. My answer to that is yes. And I point to 1975, 1976, and 1977 as an example of what I am talking about. And if you will notice in the chart in the back of my prepared testimony—it's this chart here, Senator, the one that indicates that deficits and the T bill rate do not go together—you can have a deficit going down and interest rates going up. You can have deficits going up and interest rates coming down. And I point to these years as examples of that.

Senator BYRD. Well, I have figures from the Federal Reserve Board and the Council of Economic Advisers. You mentioned 1975—the inflation rate was 7 percent, and the average prime rate was 7.8 percent. In 1976 the inflation rate was 4.8 and the average prime was 6.8. And in 1977, another year you mentioned, the inflation rate was 6.8 and the interest rate was 6.8. Then we come to 1981, and the inflation rate was 8.9 and the interest rate was 18.8. Can you explain the doubling of the interest rate vis-a-vis the inflation rate?

Secretary REGAN. It is a very difficult and a very imprecise thing that I am going to try to explain, Senator, because no one knows for sure what this answer is. There is an uncertainty in the minds of those who lend money and in the minds of money managers who have to manage other people's money as to exactly what is going to happen to the economy of the United States. Are we going to be in for permanent inflation? If we are, at what rate? Or, will we in the administration, working with this Congress, get our deficits down? Will we get the rate of inflation down? If we can do that, the premium will subside.

Also, the third factor, I think, that worries them is the volatility of the money supply emanating from the Federal Reserve. Although they are on target year over year, the way that they arrive at their target, with this extreme volatility, also worries the money markets.

So that combination of factors started in October of 1979, surprisingly at the same time the Fed changed its targets, and since then we have had 2½ years now of this major uncertainty in the minds of the markets. I think it will subside if they see that we in the administration are going to stick to our plan and that you in the Congress are going to come along with us in cutting Federal spending.

Senator BYRD. I have got one quick question, if I may, Mr. Chairman.

The debt ceiling was increased last year, presumably to take the Government through September 30, 1982. It was increased to 1 trillion and 79 billion. When do you estimate that the Congress will need to consider an increase in the debt ceiling?

Secretary REGAN. Unfortunately, Senator, I have to tell you that it will be in April of 1982. I think that we probably will hit that debt ceiling sometime in May; and to allow ourselves some room to debate this, I think it will be April that I will be back here asking that you raise that ceiling.

Senator BYRD. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Next is Senator Heinz.

First, I want to acknowledge the presence in the committee room of our former colleague and ranking Republican, Senator Curtis of Nebraska. We are glad to have you here.

Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman.

Mr. Secretary, I would like to go back to your corporate minimum tax proposal, if I may. And certainly, I don't think you would find much disagreement from any member of this committee that if profitable corporations aren't paying their share of taxes, there is something wrong with our system.

Now, a year ago when you came before the committee to propose certain changes in the tax law, you did not propose a corporate minimum tax. Last fall, when the Administration proposed certain revenue-enhancement measures, you did not propose a corporate minimum tax.

Now you are proposing a new corporate minimum tax. The question is: What is different? What has changed? I suggest to you that what has changed is that the leasing provisions that the administration inserted in the ways and means tax bill are totally flawed and without much in the way of merit, and that that is what has changed. And that what you are trying to do, which I think is understandable in its intent, is to crack down on the insurance companies that are buying all these unexpired tax credits from the auto and steel and airline industries and are getting a tax break for only their paper entrepreneurial abilities. It's something you would like to crack down on; so would I. But is it not true that as you do that you are going to be forcing the companies that you last year said you wanted to help—the auto industries, the steel industries, which don't make much money; indeed they are making losses more than money. They are not making much steel or autos, either. Isn't it true that what you propose is going to hurt the industries that we want to help revitalize and which your accelerated depreciation ACRS proposal was designed to try and stimulate? Is that not the case?

Secretary REGAN. No, Senator. Let me first back up and talk about these proposals in view of last year.

You will recall that one time last year we were talking about one tax bill and then a second tax bill following on it. We never got that second tax bill, for various reasons.

Senator HEINZ. No; you didn't.

The CHAIRMAN. One did pass the Senate. We are in conference now. It wasn't a big one, but it was Members' expenses. That made it. [Laughter.]

Senator HEINZ. That was the Dole amendment. [Laughter.]

Secretary REGAN. I'm not going to touch that one, Senator. [Laughter.]

Senator DANFORTH. You are the only one who hasn't. [Laughter.]

Secretary REGAN. No; but we did make the ruling on it; I will admit that.

We did have several of these proposals that we surfaced in September of last year, that we are now bringing forth again.

Senator HEINZ. Did you have a minimum tax proposal last September?

Secretary REGAN. No, not a minimum tax.

Senator HEINZ. That's the only thing I meant.

Secretary REGAN. But we did have the modified co-insurance and things of that nature.

Senator HEINZ. I'm talking about the corporate minimum tax, though.

Secretary REGAN. As far as the corporate minimum tax is concerned, we are not sure that we would agree with you that leasing was totally flawed, particularly the adverb "totally." We want to see our study first, before we make that judgment; because it may have some very good effects, particularly in helping some of these industries that otherwise would have to go to banks, borrow at 16, 17, 18 percent in order to get their new machinery, new plant, new equipment. We are trying to help those companies.

You recall also that leasing helps the new industries.

Senator **Heinz**. Mr. Secretary, excuse me. I understand that, but I did ask a specific question as to whether or not your proposal would in effect increase taxes, or have the affect of increasing taxes, on industries like autos and steel which are not having a great time. Can you just give me an answer to that question? Because there is another question I would like to ask you.

Secretary **Regan**. I am coming to that, Senator.

What affects the steel industry is how the steel company's accounting is put together. If that steel company has an oil company that it owns, if it has a mine that it owns, a coal mine, things of that nature, depletion does come in. The corporate minimum tax, therefore, will come in. If they don't own oil companies or if they don't own mines, then they will not have the corporate minimum tax preference item to come into effect as far as their tax rate is concerned. So what I am suggesting is that the minimum tax would affect steel companies differently, and you would have to take it company-by-company rather than as an industry as a whole.

As far as the automobile industry, again, as far as I know, there is only one company in that industry that is profitable at this particular moment. So the others are paying no taxes whatsoever. So therefore the minimum tax would not apply to them. So it wouldn't hurt them.

Senator **Heinz**. In the limited time remaining, let me ask you this. We here in the Congress have gotten into the habit, since broken last year, of passing a preliminary budget concurrent resolution, the so-called first, and then an allegedly final one, the so-called second budget resolution.

The second budget resolution that we passed last year, as we all know, was a farce. It was passed in the late fall. It didn't correspond to reality. The resolution that we tried to make work was the first one.

I would be interested in your reaction, Mr. Secretary, as to whether or not we shouldn't have just one budget resolution, pass it this spring, and, most importantly, tie it to the debt ceiling for the coming fiscal year, so that our budget resolution would not be, as was our last one, totally meaningless.

Secretary **Regan**. I would suggest, Senator, that in my opinion the debt ceiling is going to be action-inducing on the part of the Congress. And I suspect that there will be a lot of things tied to that debt ceiling as it comes through.

Senator **Heinz**. That is an understatement, Mr. Secretary. Does that mean you would rather not answer my question as to whether you think we ought to have one budget resolution, one debt ceiling that goes along with it, enact it early, like this May 15th, and that that will be our financial plan and it will have a self-enforcing mechanism—the debt ceiling—that will enforce us to stick to it? Or at least when we don't, we will know what we have to do?

Secretary **Regan**. Since I am appearing before the Senate Budget Committee tomorrow, I don't want to commit myself in advance until I hear what they have to say.

Senator **Heinz**. Oh, go ahead, Mr. Secretary. [Laughter.]

Secretary **Regan**. But I do suggest this to you, Senator, I think we would have to look at the legalities of that. I think maybe the budget act now requires the Congress to, and you may have to change the law if you are going to have only one budget resolution.

Senator **Heinz**. Mr. Secretary, I think that's correct. My question is not whether or not we have to change the laws, but whether or not we should.

Secretary **Regan**. Well, I would like to see what your action is first, before I comment on that one.

Senator **Heinz**. Clearly, Mr. Secretary, the Budget Committee will have you to themselves tomorrow.

Thank you, Mr. Chairman.

The **Chairman**. Senator Danforth, then Senator Baucus.

Senator **Danforth**. Mr. Secretary, let's assume that we in the Congress decide that the No. 1 economic problem before the country is high interest rates, and we want to do what we can to bring interest rates down, to bring them down as far as we can and as quickly as we can. What should we do?

Secretary **Regan**. Well, I suggest, Senator, there are several things that can and should be done. First of all, the country has to be assured that the amount that the Federal Government is going to take out of Gross National Product will be declining year-over-year. So, therefore, you would have to make some further budget cuts in order to insure that that does take place.

The dimension that we have suggested is $30 billion. The President has indicated that if the Congress wishes to go further in those cuts, that he would be agreeable to discussing it with them.

The second thing I think you would have to do is to make absolutely sure that the monetary policy of this country is as the Fed has described it, a slow, steady growth in that money supply, not a volatile one, not one that is overly easy, and one that is certainly not too tight; because if you have a very easy money policy, you spook the markets. On the other hand, if you have a very tight one, you choke them off. So a slow, steady growth is a type that we should achieve. And their goal, particularly in the upper part of their range near 5½ percent, should be enough to give us the nominal GNP that we are looking for, in the 10 to 11 percent.

Now, if those two things, and obviously these tax increases—let's not call a rose by any other name—these tax increases that I have just suggested, we think, should be enacted, with better tax collection methods. Put that together, and I think you have a reasonable package to assure the money markets and to get interest rates down.

Senator **Danforth**. I would like to ask you a question about something in your statement. In your statement you say that flatly deficits do not cause high interest rates. And you have reiterated that in answering Senator Byrd's question.

At the same time, you seem to say that the size of the deficit is important because of the signal it gives the money markets.

Which is correct? Do deficits affect interest rates, or don't they?

Secretary **Regan**. Deficits do matter to interest rates. It depends upon the type of deficit, Senator, and how the deficit is handled.

First of all, as you know, there can be deficits from too much Government spending. There could be deficits from recessions, which we are currently having. There could be deficits as the result of tax cuts. There could be deficits from a combination of these circumstances.

So it depends upon how the deficit comes about, and then, second, how is it handled? Now, if there are enough savings to go around so that when the Federal Government, the Treasury, comes to borrow, we can borrow from the private sector and from abroad, then it has less effect on the money markets than otherwise. If it doesn't, obviously the Fed has to pick it up.

Senator **Danforth**. Isn't a lot of the effect of the deficit—not on the crowding-out factor—but on the psychology of financial markets? Don't the financial markets look at the size of the deficit and say, well, we either do or don't have confidence in the direction we are headed?

Secretary **Regan**. Certainly they say that. Psychology plays a great deal in the market moves, particularly in the short run.

Senator **Danforth**. Don't you think that's the principal effect that we have right now, that the financial markets are looking at the very large deficits and are saying, "We believe that these very large deficits mean inflationary times are going to continue and therefore interest rates have to be high"?

Secretary **Regan**. I think there is a great deal of that in the market. I wouldn't say it is entirely that, though. I think that the volatility of the money supply is another thing that has them really worried.

Senator **Danforth**. Should we in Congress do something about the volatility of the money supply?

Secretary **Regan**. I don't want to leave a booby-trap for the Chairman of the Federal Reserve; he's appearing before this committee tomorrow. I would suggest that you discuss with him the chances of lessening that volatility. I know we have, and I know he is sincere in his efforts to try to reduce the volatility.

Senator **Danforth**. Do you think Congress has a role to play?

Secretary **Regan**. I don't think so. I think the Fed can handle this on their own.

Senator **Danforth**. We are just asking you what we can do to help bring interest rates down. I would be very skeptical that financial markets are so exquisitely precise that they distinguish between one kind of deficit and another. I might be mistaken, but it seems to me that their question is: How big is the deficit going to be? Is it going to be a deficit which is moving up or which is moving down? And they see very large deficits. They believe that the size of the deficit is going to grow rather than shrink, and they want the deficit reduced. They also believe that we overdid the tax bill; isn't that correct?

Secretary **Regan**. Well, I think some in the marketplace agree that that was the case, but not all. Again, it is very hard to say that there is 100-percent unanimity on anything when you come to money markets. There is a body of opinion that thinks that. I happen to disagree with that. I think that if we hadn't made these tax cuts, that there would be no incentive for additional savings or work, and what we do need is additional savings. How do we get it if the Federal Government is going to be spending the money?

Senator **Danforth**. Isn't it possible to do two things at the same time? One is to cut down on the growth rate of Federal spending, and the other is to have at least some adjustment of the tax bill we have just passed?

Secretary **Regan**. Well, to the extent that you can and should reduce the Government spending, and to the extent that you don't destroy the web that you have created so nicely last year in giving incentives both to business and to individuals.

Senator **Danforth**. But, Mr. Secretary, it is not necessary to destroy it. We had a lot of flexibility as we proceeded with the tax bill last year. The original tax bill of the administration only had two pieces to it—one was individual rate cuts and the other was 10-5-3. Congress did a lot in the meantime. And isn't it possible that we could go back and look at that tax bill, keep in place the general direction that we pursued, have a real supply-side tax cut, but have some sort of modification on the timing or on the precise amounts so that we can help close the deficit?

Secretary **Regan**. I would not go for any change in the timing, particularly on the individual tax cuts. Again, why? Well, first of all, we have the tax cut of July 1, 1982, right in place nicely as we are emerging from a recession. It will amount to some $30-$35 billion over the next 12 months. Starting July 1 it will be there, along with the $16 billion that will be coming from social security—a very nice boost to the economy at a time when it would need it.

Now, to the extent that the recovery is underway in 1983 and you want to give another boost to the economy, that is exactly the date that you should stick with—July 1 of 1983.

Senator **Danforth**. I wonder if the Secretary could answer one more question?

The **Chairman**. OK.

Senator **Danforth**. Since you have said you don't want to touch the timing, are there other adjustments that could be made in the tax bill which would not be viewed as totally abolishing or wrecking what we did last year?

Secretary **Regan**. Well, we have no such suggestions for you, Senator. What we have done here is to try to craft some modifications that are going to raise in the neighborhood of $20 billion of additional revenues. We think that that's about as far as we would want to go.

The **Chairman**. Senator Baucus.

Senator **Baucus**. Thank you, Mr. Chairman.

Mr. Secretary, you state often in your prepared remarks and also in answer to questions that we have to get spending down in order to get deficit down. Why hasn't the administration addressed one of the major portions of the spending side of the budget, that is, entitlements?

When I am talking to people in my State, and again these are in all walks of life—rich and poor, all kinds of different people from different economic backgrounds—generally the reaction is: "We've got to get control over this economy, get control over this budget, get the deficit down, address the Defense Budget, cut that down a bit, but also do something about entitlements."

Frankly, I think it's clear that because it has been a political football that it is difficult to address entitlements. But, more important than that, Congress certainly isn't going to address the question unless there is some administration leadership. And you know as well as I the degree to which the entitlement portion of the budget has grown and is projected to grow. So, why isn't the administration, if it is really honest in its pursuit to cut spending down, why doesn't it address entitlements?

Secretary **Regan**. Well, we have proposed in fiscal 1983 more than a $12 billion reduction in entitlements, $18 billion in 1984, and almost $24 billion in 1985. That would be a total of about $44 billion over the next 3 years, reductions in entitlements, generally, under the headings of medical care, of a cash assistance—SSI and AFDC, the Federal retirement program, food stamps and nutrition, and the guaranteed student loans. So we literally are going after some of the entitlements.

Senator **Baucus**. Well, those aren't all entitlements that you have listed. What about social security, medicare, military retirement benefits, Federal retirement benefits? What about all of those?

Secretary **Regan**. Well, we are suggesting a change in the Federal retirement benefits, and we also have suggested that, on social security, that we wait for the commission that has been appointed by the Senate, by the House, and by the administration, for their report which should be coming in in the fall before we make any changes or partial changes in social security.

Senator **Baucus**. It seems to me that if we are going to get our act together here as a country and as a Government, that we have to find some way to fairly, equitably apportion the burden, the cost of getting the deficit as close as possible to zero and as quickly as possible. And to do that, it has to be even-handed and equitable. Therefore, it has to address all portions of the budget, and you can't leave some section sacrosanct. Because once you leave a big section sacrosanct and exempt it, defense and entitlements, you are not going to have the confidence of the people. And that's just what is happening.

So I strongly suggest that the administration exercise little leadership, that the President himself exercise a little leadership on entitlements and on defense, so that everyone in the country, as much as possible, is fairly adjusting to the cost of getting our budget balanced.

Second, with respect to medicare, there are lots of reports that the Hospital Insurance Trust Fund is much more in danger than the Old Age and Survivors Trust Fund in social security. You are a trustee of that trust fund. Well, as a trustee, what are your proposals to make sure that trust fund is sound?

Secretary **Regan**. Well, as you know, we have allowed borrowing from that fund this year. That borrowing privilege expires in October of this year. So I think we are going to have to come up with some suggestions here as to what has to happen on a temporary basis until such time as we can get a look at what the commissioners have to say about the whole area of social security.

Senator **Baucus**. Why are you ducking this? You have been in this administration now for over a year, and you know the problems. It just seems to me you are taking an easy political out by not addressing it. The same with social security. You are just taking an easy political out. And I understand it is difficult in an election year for Republicans and Democrats to restrain themselves and demagog a little bit. I understand that. But, frankly, I think our difficulties are so alarming that we should put that aside, at least try to put that aside. And we are only going to be able to put it aside if in some way the administration maybe consults with the leadership in the Congress or to try to find a way to address them. And I don't see any effort on the part of the administration to address a very difficult portion of the budget.

Secretary **REGAN**. Well, the Senator will recall that last year, when the administration surfaced some suggested changes in social security, that there was such an outcry both in this Congress and outside the Congress, that the President asked then, "All right; let's have a bipartisan go at it." And, supposedly, that is what this Commission is doing—trying to come up with a bipartisan approach to it that will take some of the heat and perhaps give a little bit of light on the subject.

Senator **BAUCUS**. That is the hope; but I must tell you that it is my reaction that that is just an expedient cop-out. You will push it off until next year, and the so-called bipartisan really is certainly not non-partisan; that is, it tends to be very political. And I would like to see the administration attempt, anyway, some nonpartisan bipartisan solution to this problem. It is a severe problem.

And I must repeat that until the administration does, s well as the question of defense, I don't think that the present administration program is going to get any more confidence than it now has. And it doesn't have much confidence.

To repeat, when I was home in my State of Montana, I was frankly very surprised at the degree to which people from all walks of life, particularly businessmen, bankers and people from the financial community, felt that the present program is wrong, that we have to exercise a little commonsense.

Frankly, what I think has happened here to a large degree is that the supply-side economics sounded good: it sounds good because it is having your cake and eating it, too. It's, "Gee whiz, a big cut in taxes, and then we can have all these wonderful programs—defense, and all these entitlement programs." You just can't have it both ways.

There is beginning to be a feeling, I think, in the country—out of Washington, out of New York, and out of financial circles—which I think is just basic good commonsense, that you pay for what you buy; you have got to balance the budget, and you can't have it both ways. You can't have defense and all these other programs and not pay taxes for it.

To a large degree, I think that there is more commonsense out in the country than there is in Washington and New York and in the Fed, and so forth, where these basic programs are concocted somewhat on the basis of avarice and somewhat on the basis of rationalization, but not rooted in just basic commonsense.

So I suggest if you get together a program along the lines that Senator Danforth suggested—you know, he's off a little bit on some with this tax cut. Montana businessmen don't have any taxes. It's not taxes which is stifling initiative and preventing productivity; it's high interest rates. It is not high taxes. Not at all. And we would say it over and over again: It's not the taxes—whether on the individual side or the corporate side—which is impeding growth; it's high interest rates which is stopping growth.

Secretary **Regan**. Well, the Senator will recall that when I was here just about a year ago everyone was saying inflation is the problem, and inflation is the problem, and you should get inflation down. I submit that inflation is down now.

Senator **Baucus**. I submit it is, too. It is down now. Let me just take half a minute here. It is down now. We have a slightly different problem now. It is interest rates. So let's address that.

As you know, in politics and everything else it is perception which is more important than reality, anyway.

Secretary **Regan**. As night follows day in all of economic history, Senator, interest rates follow inflation down. And if inflation comes down and stays down, interest rates will come down and stay down.

Senator **Baucus**. Well, we live in a very complicated economy. I just suggest that if the public feels that interest rates is the problem and if deficits are the problem, it is probably due to spending. And also the tax cut is too big. If that is the perception, that is the feeling—and I tell you that is very much the feeling—then let's address that so that business then can go ahead and invest.

Secretary **Regan**. We will be very happy to work with you on further cuts in the budget, then, Senator.

The **Chairman**. I might say, and then Senator Moynihan is next, that Secretary Schweiker will be here. We are going to have an opportunity in this committee to vote for some entitlement changes. So I am glad to count the Senator from Montana as an ally. I thought I had only one vote. [Laughter.]

Senator **Baucus**. As the Senator from Montana suggested, though, it should be bipartisan.

The **Chairman**. Well, that would be one of each.

Secretary **Regan**. Or nonpartisan. [Laughter.]

The **Chairman**. Senator Moynihan, then Senator Long.

Senator **Moynihan**. Mr. Secretary, just a small point. I believe you said that the borrowing authority for the trust funds expires in October.

Secretary **Regan**. It is December. Excuse me.

Senator **Moynihan**. Could I speak to that point of what happened in the last Congress to social security? There was rejection of the administration's proposal presented as a proposal to maintain solvency of the system. The rejection was based primarily on our perception that that wasn't why the administration was proposing to cut by 40 percent the benefits of persons retiring at age 62 starting last month, but that it was looking for ways to close the deficit being brought about by the policy.

In all truth, sir, in The Budget in Brief, on page 10 you say, or the administration says,"the final factor contributing to the worsening of the budget outlook is that all of the budget savings we had planned for last year were not actually achieved—most importantly, our plan on social security." That was presented.

You now say that what we said was the case wasn't the case. I don't want to argue it; but you are not going to use social security as a device for affecting fiscal policy. It is a separate program, and should be kept separate in our view.

But could I say, sir, in the view of many of us, and the majority, as it proved, I believe the chairman's resolution, which I had prompted, perhaps, passed 96 to nothing.

Mr. Secretary, last week our distinguished chairman proposed that you put an end to the leasing. I thought I heard you, in your earlier exchange with Senator Danforth, suggest that you were at least flexible on some measures.

As you know, part of that leasing system involved the right or the ability of public transit systems to purchase equipment—buses, subway trains—in the same arrangement as if they were private. And the administration, having proposed to abolish all mass transit assistance—construction and operating subsidies—I would hope you would see that as a respectable public purpose, that was adopted conciously by this committee to let mass transit continue. Otherwise, it is going to close down, not just the subways and the bus routes, but the plants that make buses and subways. Would you not find some part of your heart as an old New Yorker in favor of that? [Laughter.]

Secretary **Regan**. Well, I do believe in rent-a-bus. I think that's not a bad result of the leasing provision. The only exception I took to the chairman's words were because I was inundated with phone calls at Treasury—not only I, but a lot of my assistant secretaries—over the statement of the cutoff date; because there are a lot of people planning and trying to make business plans. And that sort of shook him.

Senator **Moynihan**. Well, surely. And you have made that point before in this committee.

But I did hear you say that you are very much in favor of rent a bus.

Secretary **Regan**. Yes.

Senator **Moynihan**. And rent a subway car? [Laughter.]

Secretary **Regan**. With or without graffiti? [Laughter.]

I would say, from the point of view of leasing in general, I think that proposal did have merit last year. I still believe that it has merit. Because I think in an effort to help both new industries and industries that have fallen on bad times, that they are helped by this as well as the other corporations. I see nothing wrong with the philosophy behind leasing.

Now, I am definitely holding off on any adverse comments on leasing until such time that I see what the study brings out.

Senator **Moynihan**. A fair point.

Could I then go to the question I said I was going to ask you, which is: In your statement you said in the short run there will be substantial deficits, due primarily to the recession. Now, your former Assistant Secretary of the Treasury for Economic Policy, a man you chose for the job, Mr. Paul Craig Roberts, published in Fortune magazine an article entitled "The Stockman Recession—a Reaganite's Account." And he said—he, having resigned from the Treasury—that the present recession was brought about by the policies of the present Government.

Let me ask you, how do you feel? Because, in all truth, sir, not you but an awful lot of people arrived in this town a year ago supremely confident of their doctrines. And there turned out to be more than one.

He says, for example, that none of the people in the economic policy group were Lafferites. That might surprise the President.

But do you agree with Mr. Roberts? Is this a Stockman recession? An administration-caused recession? Or, if you don't agree with him, how come he got to be Assistant Secretary of the Treasury for Economic Policy? [Laughter.]

Secretary **Regan**. Well, he certainly didn't get to be Assistant Secretary of the Treasury for Economic Policy on the basis of one article. It was on the basis of his beliefs. Craig Roberts is a brilliant economist and a man for whom I have the highest admiration, and I hope a man to whom I can turn for advice from time to time. We parted on very amiable circumstances. As you know, he was offered a chair at Georgetown, a very prestigious chair, the William Simon Chair, named after a predecessor of mine. And a result, he wanted to assume that chair. That's the reason he left.

Senator **Moynihan**. Are you sure it wasn't that he wanted to write this article? [Laughter.]

Secretary **Regan**. Well, one also has to remember that when economists disagree—and I'm sure you are well aware of this, coming as you did from the academic life—when economists disagree, they disagree violently with each other. And they hold to their positions much more so than us pragmatists or practitioners of finance.

Accordingly, that is Craig Roberts' opinion. I do not share it. I do not think one man is so powerful that he could induce a recession in the United States all by himself. I think there is enough blame to go around in many areas for how that recession actually came into being without trying to pin it on one man.

Senator **Moynihan**. But you do grant that a senior official in economic policy for the administration says that the recession we are in was brought about by the policies of this administration, and is not a hangover from the excesses of the New Deal?

Secretary **Regan**. Well, as I say, that is part of his thesis. I am not sure it is his only thesis, but it is part of his thesis. I think he regrets that this Congress didn't enact the Roth-Kemp bill in its pristine form—10-10-10, July 1, 1981. Had that happened, he thinks that there would not have been a recession. So, to the extent that the Congress didn't pass that, I think there is a little blame there. And I think past policies of previous administrations have to be charged with something for this recession.

Senator **Moynihan**. There were a lot of mistakes made in the McKinley administration.

Mr. Chairman, could I just ask one more question? Because this committee is full of economists, you know, and we love these things.

He said, "None of the supply siders within the administration were Lafferites, promising higher revenus to lower taxes." Would you agree with that?

Secretary **Regan**. I am not sure that I understand his reference, to who in the administration he was referring to as Lafferites.

Senator **Moynihan**. Well, the President, for example, in Flint, Mich. in May 1980, said, "We will take the increased revenues that come from the decreased taxes and use that to rebuild our defense capabilities." That sounds Lafferite idiom to me. [Laughter.]

Secretary **Regan**. Well, I wouldn't say that's more laughable than Laffer, but I would say that from the point of view that what we have here is a policy that has not yet been put into practice—remember that this is a three part program, the tax cuts. All of them have not been enacted. You are asking on the basis of a 1¼ percent reduction in the rate of increase in taxes that everything be made smooth. That simply is incredulous.

Senator **Moynihan**. I wasn't asking that. I was asking about your opinion about your former assistant. Thank you very much.

The **Chairman**. I want to clarify a point. What the President said in Michigan is not laughable.

Secretary **Regan**. No, no. I am saying what Laffer is saying is more laughable than Laffer.

The **Chairman**. Well, I saw people writing over there.

Secretary **Regan**. No, no. Laughable. [Laughter.]

Senator **Moynihan**. But would you agree that you have taken the increased revenues that have come from the decreased taxes and are using them?

Secretary **Regan**. We will, when we get the tax cuts.

Senator **Moynihan**. Write that down. [Laughter.]

Secretary **Regan**. And remember the last one comes on July 1, 1983. No tampering, sir.

Senator **Moynihan**. Thank you.

The **Chairman**. Senator Long?

Senator **Long**. Mr. Secretary, I have provided you with a copy of what I thought was some of the best advice that has been offered your administration. Try to get the President to read what the article says. If you take a Xerox, it sort of loses the impact. I thought if he could read it out of the magazine for himself he would get the point.

I have shown this to some of your colleagues. They have been impressed by it. I won't name any names but some of them are right here on this committee. They have been very impressed by this article that was printed on October 26 in Business Week. It is by Mr. Blumenthal, who held the same job that you hold.

It has a misleading title: "What Ronald Reagan Could Learn From Jimmy Carter." What he has tried to say in the article is that he is hoping that you and your President won't make the same mistakes that his President made. And some of this, I think, is really the best advice that has been ever offered from one administration to another administration by a sincere person who had the same responsibility that you have. Let me just read a couple of paragraphs:

> As the economic clouds darkened for him in 1977, President Carter's fundamental mistake was to keep trying to apply the ideas he had started out with and that quite evidently had not worked the first time around. Moreover, economic conditions had been fundamentally altered by a new oil crisis, an uncertain economy, a growing inflation psychology, and a dangerous erosion of the dollar's value in the international area. So that was ample reason for a basic change in approach. Yet, for too long, Jimmy Carter just kept playing along, convinced that he would ultimately be right, that Wall Street would see the light, and that his program would work in the end.
>
> Wherever he made changes in his economic programs, it was always with reluctance, always too little, and always too late.

Now, let me just move on to the next column.

While inflation is rising, productivity is low, economic growth stalled, and the international economy in disarray, there is no solution that is not slow and painful. No politician can for long escape this harsh truth. But the final and probably the most significant reason why the change was so hard was that Carter and his closest advisors believed for too long, even when the statistics were telling a different tale, that their original policies had been right, and they clung tenaciously to the mistaken notion that to change course was politically the kiss of death, that it was better to ignore the new numbers and hang tough. The critical error here was not just the failure to appreciate the chronic unreliability of economic prognostication but to count on their flawed predictions well past the point of no return.

While this was serious, the worst mistake was to act on the false premise that the President did in fact have a choice between "standing firm" or changing course. Against the background of changing economic conditions, such a choice never existed. To stand firm really meant to opt for a policy of constant small retreats and compromises, for a gradual though reluctant step-by-step withdrawal from stated positions. And in the public perception, with one big change the President is a leader; with lots of little changes he is vacillating. It was for this process of small retreats that President Carter in fact opted when he thought he was choosing to stand firm. And it was this process that caused him to be perceived—rightly or wrongly—as an uncertain economic leader and ultimately cost him his credibility.

Now, I would just urge you to read this article and see if the President could just read it the way it was in the magazine. You know, not a Xeroxed copy because it loses its impact. There is a guy who had your job, and who saw the President making disastrous mistakes. In fact, in my judgment, your administration right now is in the same trap that that poor man was in. I would just hope that the President sees that. It could make a big change, because circumstances have changed during the last year. With regard to leadership, to try to hang in there and say, "No, we're going to do it just the same way we did it before," when you are really coming in for a series of small changes that are regarded as vacillation, is not the wise course to make.

For example, here you are advocating tax increases, eight of them, when the President says, "You can't balance the budget on the backs of the American people, and we are not going to ask for a tax increase." Rather than opt for a series of small changes that will be criticized and ridiculed, you ought to come in here with the big change of direction.

Unless I miss my guess, Mr. Secretary, you have been advocating that right down there at the White House. And I would just hope that the President would read this article and profit by its advice. I want to see your administration succeed for the good of the country, even if it costs us some seats in the Senate or the House. But you are going to have to do some things that are sometimes tough. And I wish you luck in it.

But as Mr. Blumenthal says here in this article, "Now and then even politicians can't escape the harsh truth." And I really believe that, for the good of the administration, this man is giving you some very good advice that ought to be carefully considered.

Secretary **Regan**. Well, thank you, Senator. I will make certain that the President gets a copy of that in its original form.

The **Chairman**. I gave him a Xeroxed copy, and I guess he didn't read it. [Laughter.]

Senator **Long**. I believe you have a copy with you, don't you, Mr. Secretary?

Secretary **Regan**. I have a Xeroxed copy which I have read, but for the President I will get the original.

Senator LONG. Well, Mr. Secretary, if you don't have an original copy, here's one for you. [Laughter.]

Secretary REGAN. Thank you, Senator.

I might add, in that connection, as yet, Senator, we don't agree that either world conditions nor domestic conditions have changed that dramatically from last fall to make us want to back off on something that happened only last July and August; that is, the tax cuts and the budget cuts.

Senator LONG. Mr. Secretary, we could agree on this: that you and our chairman of this committee, Bob Dole, have been giving the President some advice substantially at variance with what you are saying in your testimony here. And all I am saying is that I think your advice has been basically correct—not necessarily in all the details, but the trend of it I think has been correct, and I think the direction that Bob Dole has been advising him in has been correct. I would urge that you two don't just go along with something without at least in a peaceful way trying to persuade your boss to see it the way you see it.

Secretary REGAN. Let me say that I have broken a couple of lances [laughter] trying to tilt at some of these things, and I'm not sure I have many lances left to break. But I understand what the Senator is saying.

Senator LONG. Well, I believe you will find a lot of people will help you with that, Mr. Secretary. I am not asking you to go down there and get fired; I know how that thing works, too.

Secretary REGAN. That might not be so bad.

Senator LONG. You mean you might be better off if it happened? [Laughter.]

All I am saying is that there are a lot of good people—business leaders and economists and people who have held similar responsibilities in Government—and I think that Paul Volcker is one of them—who would like to go along with you in some things that you gentlemen can agree on.

Do you still have that meeting once a week with the Chairman of the Federal Reserve?

Secretary REGAN. We try to keep it, schedules permitting. We usually do meet once a week. Yes, sir.

Senator LONG. Well, he's not running for office.

Secretary REGAN. Neither am I.

Senator LONG. While I don't agree with you about the level of interest rates, I do think that his thoughts about what our general program ought to be are pretty good. Basically, you know, he thinks that we ought to cut where we can cut on spending, that we are still going to have a big deficit, and at that point that we ought to look at the revenue side and that we ought to make some changes to try to improve our picture on that side. And he believes that that's what is going to have to be done in order to bring interest rates down.

Now, I think that fellow is in a different position than most of the Chairmen of the Federal Reserve. He got there without making any commitments to the guy who appointed him—any commitment of any sort. At least I think that is so.

I would hope that you, working together with Mr. Volcker and others, can bring about something that is going to bring these interest rates down and get this economy moving as I know you want it to move.

Secretary **Regan**. Well, that is our No. 1 priority, to return prosperity to this country. And we will be working toward that end.

Senator **Long**. Thank you, sir.

The **Chairman**. Senator Bradley.

Senator **Bradley**. Mr. Secretary, at what point do you feel that your adversaries within the administration will begin to see that the program isn't working?

The number that disturbs me the most, that I have seen in the last couple of weeks, is the productivity drop in the last 2 months of 1981: A 7-percent productivity drop and an 11.3-percent manufacturing-sector productivity drop. Now, I don't know what that tells you, but that tells me that there are a lot of firms who have had a dramatic dropoff in sales, a dramatic dropoff in production, but they haven't let their workers go yet; they have kept them on—kept their salesmen and their skilled workers on.

Now this is building up. And my fear is that if there is no change of direction, we could find ourselves by midsummer in a much more problematical employment situation than you or anyone else expects. My question to you is: When will we be able to get this message through to your adversaries within the administration?

Secretary **Regan**. Well, I don't know that I have adversaries within the administration, Senator. I wouldn't characterize it that way. But I would say this: From the point of view of the economy itself and when it can get going, we are expecting that the second quarter of 1982 is going to be a plus.

Senator **Bradley**. Let's assume that that doesn't happen. Is that the watershed? I mean is it the second quarter? If we don't have the growth that the administration is projecting? Is that the point?

Secretary **Regan**. No; I wouldn't say it's the watershed. But I think, actually, that everything that we have put in place would indicate that it should come at that particular time. Together with the boost that will come, if you wanted to go from a Keynesian point of view, the boost that will come to consumption from somewhere in the neighborhood of $45 to $48 billion annually could start at May 1.

Senator **Bradley**. Well, could we stop at that point? Because you made this point in your testimony. You said that the tax cut was coming just at the right time, because we are coming out of the recession.

Remember the tax cuts were billed as being tax cuts for economic growth, not tax cuts to pull the economy out of a recession. And you either have one or two choices. Those tax cuts are either saved or they are consumed.

Now, if you say that they are going to be saved, then what is going to pull us out of the recession?

Secretary **Regan**. Well, I think what you have to look at is that the individual portion of the tax cut will—both will be done. It will be both the consumption as well as a savings type of tax cut. From the point of view of business, of course, it will be entirely savings. Putting the two together, we expect that somewhere in the neighborhood of 60 to 65 percent of that tax cut will occur in the form of savings. And the remainder will be consumed.

The social security portion we suspect will be entirely consumed. So that there will be a division between consumption and savings there.

Now, as far as the tax cut being billed one way and then actually something else coming about, I don't think any economist, particularly early on in the early part of 1981, was projecting a real deficit in the nature of—well, it's currently a minus 4.7-percent drop in real GNP in the final quarter of 1981. I don't think anyone projected that.

So as a result, what we have here is something that was not expected and the depth of it not expected, and we are trying to work our way out of it.

Senator **Bradley**. Well, my point is I think what we need is a sustainable economic policy, not one with the extreme premises or prescriptions. And that was my argument throughout the tax bill last year.

Now, we've gotten this big tax bill; it has extreme premises and prescriptions; and the program was supposed to deliver, according to your testimony and OMB's projections, unemployment of 7.2 percent and now it's 8.9 percent. It was supposed to deliver growth of 4.2 percent; we'll be lucky if we get to plus 2 percent. It was supposed to deliver interest rates of 8.9 percent; we will be lucky if we get interest rates at 11 to 12 percent.

Now, at some point there has got to be a recognition that things are not working. I saw a recent study done by Mellon Bank of Pittsburgh, in which they estimated that roughly 50 to 60 percent of personal savings in this country will go to the financing of direct and indirect Federal debt. Now that means you have got all the companies that are supposed to be producing growth competing for the remaining 40 percent of personal savings. Now how is that not a prescription for higher interest rates?

Secretary **Regan**. Well, as you know, in this chart that we have in the back of my testimony there—although it is not in color as this one is—this shows domestic private savings increasing rather than decreasing. And it shows in red there the proportion that the Federal Government will be borrowing.

Now to the point that our Federal borrowing does not have the crowding-out effect, I don't think that it is going to take 50 to 60 percent of gross private savings or anything like that in the outyears; because not only do we have a natural increase in savings year over year, but we have the tax cuts.

Senator **Bradley**. But are you saying that if it does take 40 to 50 percent of gross private savings, then that's a recipe for higher interest rates?

Secretary **Regan**. Oh, yes.

Senator **Bradley**. OK.

Then the question is: What evidence can you provide the committee that these savings rates that you have described—you said $450 billion in 1981—are going to go to $760 billion? And if it is going to be that kind of shift out of consumption to savings—we only have savings or consumption—how is that not a recipe for continued stagflation?

Secretary **Regan**. Well, from the point of view that something will be done with those savings. Those savings are not going to lie fallow in banks, and the like.

Senator **Bradley**. OK. You are saying that the recovery is going to be led by capital spending.

Secretary **Regan**. Yes. Well, initially by consumer spending, and then later by capital spending. In the short run, over the first few quarters of any recovery period, it is actually consumption that leads, and then capital spending works, too.

Senator **Bradley**. All the businessmen I know in New Jersey are withholding their investment because interest rates are too high. They are saying they can't make the investment until interest rates get down to 12 and 13 percent.

You know, I think you are caught here. And sooner or later you are going to have to address the problem.

Secretary **Regan**. Well, what we are saying is that we think interest rates will come down into that area this year.

Senator **Bradley**. This year?

Secretary **Regan**. Yes.

Senator **Bradley**. Eleven percent?

Secretary **Regan**. That is what we are forecasting. Actually we are forecasting somewhere between 10½ and 11½ percent on T-bills, and all other rates accordingly.

Senator **Bradley**. Do you have in your own mind a contingency plan? You know, if growth isn't so high, you have a much bigger deficit. If unemployment is not as high, you have a much bigger deficit. You have got some real problems out there, and this buildup in potential unemployment—11.3 percent decline in productivity in the manufacturing sector—is ready to burst if this program doesn't work out the way you have projected.

Now, do you have contingency plans for that?

Secretary **Regan**. We will have and do have contingency plans, yes. You obviously have to; but they are not something that you disclose, because you try to make certain before you enter into a contingency—and this is partially what Senator Long was driving at, that once you are convinced that the thing isn't working, then you have to make a major change. But as long as you are convinced that the thing has a chance to go, which Ronald Reagan believes, that his program at this time will go——

Senator **Bradley**. What do you believe?

Secretary **Regan**. I am right with the President on that. I think the program will work.

Senator **Bradley**. And what about the guidelines? Where do we judge is it working or is it not working? Last year, clearly, it didn't work as projected, and you didn't meet the numbers. So the question is, where along this path do we say, "Look, it's not working; we'd better change"?

Secretary **Regan**. Well, I think that you have to give the program, as I suggested in testimony last fall before this committee, at least a year to be in effect.

Senator **Bradley**. A year. So you are saying by October. By October 1, if the projections of the program have not been reached?

Secretary **Regan**. Well, I don't want to be precise about October 1; but I would say in the fall of this year if the program isn't working, then you obviously would have a chance to say that the thing isn't going to work; we should change. But, on the other hand, if it seems to be working you wouldn't tamper with it.

Senator **Bradley**. Is that what's behind the strategy to try to push off as much of the budget decisions this year until late fall?

Secretary **Regan**. Oh, no. Far from it, because the budget cuts are needed in order to reassure the marketplace that the portion of GNP that will be allocated to the Federal Government will be less each year. So unless we get those budget cuts, they won't be reassured.

Senator **Bradley**. All right.

Now, let me just conclude by asking: There are economists that are in demand, supply, whatever. I mean there are 36 different categories; you know that. Among the group of economists that could be called "friends of supply-side," like Felstein and Penner, and even one of the proponents of this big tax cut, Charley Walker, have all said, "Look, we think we ought to postpone the third year of the tax cut."

Could you tell me what is the rationale for not at least making the third year of the tax cut contingent on the health of the economy? You have just said that by next October you will know if the program is working or not. So why should we have locked ourselves into a tax cut in July of 1983? Wouldn't it be more reassuring to your friends on Wall Street that you talk to, as it is to some that I talk to, if indeed you made it contingent, so you would see some source of revenue?

Secretary **Regan**. I think that what you have to take a look at here, Senator, is what are you making it contingent on, and why are you making it contingent?

First of all, I assume you are talking only about the individual tax cut. Were you to do away with that tax cut or to make it contingent, what you would be saying is: OK, the program isn't working, therefore we are in a worse recession, we are in worse stagflation because your program isn't working, and therefore we are going to tax you more.

Now, I don't see the sense of that, that in a period of worsening conditions that you would be actually increasing taxes on a person, at a time when you had a bad recession or stagflation continuing. Now, if our program works, obviously it is prosperous times.

Senator **Bradley**. Right. And therefore there is no need to make it contingent.

Secretary **Regan**. Well, wait a minute. That means that what you are saying is that in prosperous times you should not give people a tax break, that you should let the money go to the Federal Government for additional spending.

Senator **Bradley**. No. I am saying if the program is working, the tax cut goes through.

Secretary **Regan**. Pardon?

Senator **Bradley**. If the program is working, the tax cut goes through. But if interest rates are much higher than you have projected——

Secretary **Regan**. But I have turned the coin over and am saying: Why, if the program doesn't work, do you want to increase taxes? Because if the program doesn't work, you are in a worse recession.

Senator **Bradley**. That is a matter of speaking here. You say increase taxes. OK? For most Americans this tax cut means $4 a week. But you and I both know that they are not investing. And in exchange for that $4 a week they have in their pockets through this tax cut they have got interest rates of 15 percent; they are supporting an unemployed relative; they are paying more for their kids' education; and they are going to be saddled with higher State and local taxes. Now in my view that is pursuing this policy with an ideological fervor that is not in our country's national interest.

Secretary **Regan**. May I answer that for just 1 minute?

The **Chairman**. Yes.

Secretary **Regan**. This is a chart here that shows a worker with a $20,000 income and what happens if we postpone the 1983 tax cut, what happens to his taxes. And you can see that his taxes go way up as a result of that; $3 to $400 per year for a $20,000 worker, one wage earner in the family, four people in the family.

Senator **Bradley**. What is that per week?

Secretary **Regan**. On a per-weekly basis it amounts to—in 1985 it is something in the neighborhood of about $6 a week. But when you only have got $20,000, $6 a week is a hell of a lot of money that you would rather have than give it to the Government.

Senator **Bradley**. But if you can't buy a house, and your relative's food cost in your house is more than $6 a week, where is the balance?

Secretary **Regan**. But, Senator, what you are saying is that you should take the money away from that individual and give it to the Federal Government. And we are saying: No, let the individual have it to spend on his relatives or food.

Senator **Bradley**. I am saying the individual would have more disposable income than he would if he got the $4, because he would have less expenses due to interest rates, supporting the unemployed relative, and paying more for education and higher State and local taxes. That is what I am saying.

Secretary **Regan**. No, I couldn't agree with that.

The **Chairman**. We always allow him a little more time. He voted wrong. [Laughter.]

Senator **Matsunaga**. Thank you, Mr. Chairman.

Mr. Secretary, is this administration concerned about reducing or eliminating the deficit in our balance of trade?

Secretary **Regan**. Yes.

Senator **Matsunaga**. Would you agree that the greatest single contributing factor to our balance of trade deficit is our continuing vast imports of foreign oil?

Secretary **Regan**. No.

Senator **Matsunaga**. You would not? I am surprised.

Secretary **Regan**. I would have to know what the whole equation is here, what you are talking about. In regard to our import policy?

Senator **Matsunaga**. Well, when did we begin to see a deficit in our balance of trade?

It was when the price of oil jumped from $2.40 a barrel to $10 to $26 to $36. It was when our payments for oil in 1972, which was less than $5 billion, jumped to nearly $90 billion in 1980. Is that not true?

Secretary **Regan**. Yes, but we also——

Senator **Matsunaga**. When we suffered our greatest deficit in the balance of trade, because of that tremendous payment for oil which escalated and kept on escalating.

Secretary **Regan**. But on the other hand, you have to take a look at what we could have been exporting and why we failed to export, and why we priced ourselves out of the markets in a lot of areas, and why we had to import a lot of cheaper products from other countries. So that's why my short answer is "no." I think it's more involved. It is not as simplistic as that, Senator.

Senator **Matsunaga**. Well, would you say that excessive oil importation is "one" of the factors contributing to our trade deficit?

Secretary **Regan**. One of them I would agree with. Yes.

Senator **Matsunaga**. All right.

In Hawaii, we import about $1.5 billion worth of foreign oil, which leaves the State in an annual trade deficit of about $300 million. If we in Hawaii could only eliminate or substantially reduce that, import of oil, we would not have a trade deficit.

Now, as I see it the best way to reduce our imports of foreign oil is to develop our own indigenous sources of energy. Do you agree?

Secretary **Regan**. Yes.

Senator **Matsunaga**. All right.

Why, then, does the administration insist on eliminating tax incentives for renewable energy development? The President in last year's budget address on September 24 proposed to repeal the business energy tax credits so as to raise revenues. In response, 62 Senators, including a majority of this committee, and 266 Members of the House cosponsored a resolution of disapproval. As you know, that resolution was incorporated into the fiscal year 1982 continuing resolution.

The President again proposed the repeal of the business energy tax credits in his budget message of January 26 of this year. Eleven members of this committee, Democrats and Republicans alike, sent a joint letter to the President stating their opposition to the repeal. Several other Senators have sent individual letters to the President to the same effect. It would seem to me that with the majority of this committee, the Senate, and the House on record opposing the repeal of the business energy tax, your request would be most unlikely. Yet, the administration persists in proposing repeal of the energy tax credit.

The thing that bothers me most is that every time the administration proposes repeal, financiers pull back from funding renewable energy projects. I will give you an example. There was a proposal to build an 80-megawatt wind farm on the island of Oahu where Honolulu is located. Now, when the President made his announcement on September 24 of last year, the principal money backer pulled out of the deal, because only the tax incentive would have made the project profitable.

Businessmen throughout the country have complained to us, and I am sure they have gone to see you, about the administration's persistence in eliminating completely the energy tax credits.

Now, my question to you is: Why? You speak of obsolete incentives. This is not an obsolete incentive. It has served a great purpose in speeding the development of energy sources which otherwise would have been slow in developing. Hawaii has geothermal, ocean thermal energy conversion, solar energy, and biomass energy projects, which would have been delayed had it not been for these tax incentives.

Secretary **Regan**. Well, I will try to answer that, Senator. First of all, you know that a lot of these credits will expire automatically the end of this year, and there are only certain ones that continue on to 1985, a period of another several years.

What we are saying is that, since the passage of ACRS, since the passage of the leasing provision, since the investment tax credits are in effect, and since the price of oil has been decontrolled and now, thankfully, is starting to fall, that these projects now should stand alone with just the normal tax incentives. And certainly, from what I have heard from some of the other Senators, they think that leasing is a little bit too much of a tax break, and they don't want the minimum tax, which would imply that a lot of people would not pay any taxes—a lot of corporations.

Now, with that background in mind, I fail to see why there has to be a special privilege if renewable energy development is at all market efficient. If it is market efficient, then it should stand on its own and compete in the marketplace with other devices, whether it is gas fuel or oil fuel or wind fuel or geothermal or nuclear.

Senator **Matsunaga**. Mr. Secretary, as you well know, alternative energy developments to be self-supporting must be commercialized. Once commercialization is achieved, outside supports are no longer needed. But at the beginning, incentives are needed to assist development and commercialization.

I will give you just one example in the geothermal field. The Federal Government provided program support for geothermal exploration in Hawaii. After one well proved successful, four additional wells were drilled without any further Federal or State support.

But the business ventures that drilled the new wells were banking on the tax incentives to commercialize geothermal energy development. They were willing to go ahead, because the business energy tax incentives made geothermal energy competitive with other conventional sources of energy.

Secretary **Regan**. Well, you realize that if a project is started we will have grandfathering, and things of that nature, so that any project that is started now and is in being will continue to get these tax breaks. What we are saying is that they have had quite a few years to get these started. They have known for quite some time that the tax provisions were going to expire. And it is time now to cut off this subsidy, let those projects that were demonstration projects, that were to have led to this development, do so—there are, after all, quite a few wind projects tried elsewhere. This is not the only one.

Senator **Matsunaga**. My time is up, but I might merely comment that grandfathering alone is not sufficient. We need to have more of these projects so that we can cut down our need for foreign oil imports.

Thank you, Mr. Secretary.

The CHAIRMAN. Mr. Secretary, I understand you are willing to proceed with the questions of Senator Symms, Senator Mitchell, Senator Grassley, and Senator Boren on the first round.

Secretary REGAN. Yes.

The CHAIRMAN. And there may be some coming in from rest and lunch who want to start on the second round.

So, Senator Symms?

Senator SYMMS. Thank you very much, Mr. Chairman.

Mr. Secretary, I have been interested in listening to the discussion here this morning, and it seems that many people like to say that Reaganomics isn't working, so we need the change, that supply-side economics isn't working, so we need the change. But do we really have Reaganomics or supply-side economics as it has been sold in the campaign of 1980 to the people in place yet?

Secretary REGAN. Oh, no, Senator. First of all, you will recall that the tax cuts were to have been 10-10-10 and started much earlier. We now have 5-10-10, and only the 5 is in effect now.

Second, we haven't had any chance for the return flow yet to get the savings, and the like.

Senator SYMMS. Thank you, Mr. Secretary, but that is exactly my point. Now recently in the Washington Post there was an article that Columbia University had done a poll and had pointed out that 85 percent of the 4,600 Washington journalists had voted for George McGovern and 81 percent voted for Jimmy Carter. So they can't help but have an ideological bias to report to the public that Reaganomics is failing. Why are we keeping Ronald Reagan—why isn't he out on television explaining to the American people that Congress hasn't even begun to scratch the surface on the spending side of the equation yet? We haven't even tackled the so-called entitlement programs. So we are still spending money at a very, very rapid rate that we don't have, forcing interest rates up.

I would just urge you as one of the senior Cabinet officers to get the President on television to tell his side of the story. It is true that Reaganomics isn't in effect, and people want to change course already and go back to what got us in the problem. Isn't that correct? Raise taxes and put us into a depression.

Secretary REGAN. I would agree in general with that. Yes, Senator.

Senator SYMMS. Well, when you come down here and call for raising taxes, how do we raise taxes in an illiquid private sector without forcing those same people that we raised their taxes on to balance the budget to go to the same private markets to borrow money to pay the taxes so we still force interest rates up?

Secretary REGAN. Well, from the point of view of the changes in the Tax Code, what we are suggesting is that many corporations now don't need some of the tax breaks that were in the Code already. We are making no suggestions for any changes in the individual tax cuts. They are greater enforcement, and the like. It is not a change in the statutory tax rates, or anything of that nature. It is merely speeding up collection.

Senator SYMMS. Well, I know that is true, but I had the opportunity in 1976 to campaign with Ronald Reagan, and I heard him again in 1980 when I was in my campaign, and he always used to say, "People pay taxes; business collects taxes." So what we are doing out here is trying to squeeze blood out of a turnip. Don't we really need to cut spending? Isn't it what we spend that counts, whether we print the money, borrow the money, or tax for it? We are still forcing an illiquidity on our economy.

Secretary REGAN. Well, I think we certainly have to cut spending. I am repeating myself here, but I think that is a signal that the money markets need, the reduction in the rate of growth of the total Federal spending.

Senator SYMMS. It is to reduce spending.

Now, as a former financial leader before you came to Treasury, and you are still a financial leader, in your opinion what kind of spending cuts would have a real impact on the financial markets? In other words, the bond markets have to go up so interest rates can come down. Long-term rates need to come down. Will cuts in defense which will only be appropriated every year—we will still have to make some adjustment for defense—or a long-term across-the-board freeze of entitlements? Which would send the signal to the markets to bring interest rates down?

Secretary REGAN. That is a hard one to answer, because it is a hypothetical.

Senator SYMMS. Well, maybe I am not making it clear. Let me ask it again and rephrase it.

If we cut defense this year, then we still have to play catchup next year, and we still face the same Soviet threat. So that is a given fact that is reality. The President has been very firm on this, and for that I commend him.

But if this Congress and this administration would just come out and say the problem is that we are increasing 60 percent of the budget by 16 percent every year, by 1990, 93 percent of the budget will be entitlements. So we will have 7 percent for defense and the rest for the Government. If the President would go on television and tell that story, I think the overwhelming evidence would support him, and he could pass anything through Congress that he needed. Because I have grandfathers talk to me daily when I am in my State and say, "Why are you increasing my retirement check, when my grandson can't afford to borrow money to buy a house?" And, "The reason the interest rates are high is because the Federal Government is borrowing all this money sending me these checks." In fact, I have had some retired Government employees talk to me who said they are getting more money now than they got when they quit working because of the COLA's. Both military and nonmilitary said that. Social security recipients are saying that.

Why are we so afraid of that? Let's get the President out in front and overwhelm this news media who are saying Reaganomics has failed, when it hasn't even started.

Secretary REGAN. Well, as I suggested in answer to a previous question, we are trying to cut some of the entitlements. And we have suggested cuts there. But, as the Senator knows, this is a very difficult program to get through the Congress—these cuts in entitlements.

Senator SYMMS. But you would agree with me that tax increases are still not going to be the instant cure to interest rates that some people may think they are.

Secretary Regan. Tax increases won't do that. As a matter of fact, I think that tax increases, particularly if they are put on to individuals to where their taxes will increase year after year, will be a disincentive.

Senator Symms. I thank you very much, Mr. Secretary. You are a good witness.

The Chairman. Senator Mitchell?

Senator Mitchell. Thank you, Mr. Chairman.

Mr. Secretary, I am not an economist, but I have spent most of my adult life trying cases. And if there is one thing I recognize, it's laying the foundation for an alibi. And I want to say I think that the sequence of questions and answers here, suggesting somehow that the economic program we have in this country is not President Reagan's program, can be accurately identified as laying the foundation for an alibi. Is there any doubt in your mind that what we have in force in this country is President Reagan's economic program, substantially as proposed?

Secretary Regan. Well, I think it's a question of timing, sir. And we are not trying to alibi. This program is not all that President Reagan wanted. Indeed, he has made some suggestions, part of which I offered to this committee today, for changes in that program. So the entire program has not been enacted. And the portion that has been enacted has not had, at least in our judgment, sufficient time to work. I do think that you have to give us a little more time, and then we can take the consequences of what has transpired.

Senator Mitchell. I just want to say to you, Mr. Secretary, and I recognize your good faith in this, but I was truly dismayed at your response to Senator Bradley's question suggesting that you won't really know or be in a position to evaluate it until October 1. I want to say to you, from direct personal contact in my State every weekend with hundreds and indeed thousands of people and what I observe over the country just from reading the papers and hearing other reports, is that will be too late. There is widespread apprehension, there is widespread anxiety, there is widespread fear in this country about the state of our economy. And if the economy continues on its present course, and you say we are going to wait until October to make a judgment of whether or not this program has succeeded or failed, then, of course, there will be a lengthy period of time for any kind of analysis to suggest a change. I submit to you that's just too late for many, many people in this country.

Secretary Regan. I think the gentleman has misinterpreted the answer that I gave to Senator Bradley, or maybe I didn't make myself clear enough. I was answering there his question, "How long will it be before you think a judgment about a radical change in your procedure should be made?"

I did suggest, in answer to earlier questions, that I thought the recovery would start in the spring of this year and would continue through the summer and well into the fall and on into next year. That is what we sincerely believe. However, the Senator asked me, "In the event that it's not working, in the event that unemployment is getting worse, at what point in time would you make that judgment?" Then, and then only, did I say the fall of this year. But we are certainly not waiting until the fall to have any kind of a recovery.

We are very sympathetic to those people to whom you were talking about high rates of interest. We are very sensitive to that point.

Senator MITCHELL. Well, I just think it is a serious problem that will require a change in the administration's economic policy well before October 1. But you have covered that with others. I want to cover one other point, following up on Senator Matsunaga's questions about the energy tax credits.

The rationale that you used in suggesting the repeal of the energy tax credit is that the original reasons no longer apply to it; they have been described by the President as obsolete, the argument being that, as a result of decontrol, prices have risen.

I guess I would ask you why the same logic that you suggest applies in this category does not apply to income tax provisions designed to promote oil production? Why has not the same rise in oil prices that has made, according to our testimony, conservation and alternative energy subsidies obsolete also made production tax subsidies just as obsolete? What I am asking is: If you are concerned about the deficit and suggesting a number of tax provisions to help close the deficit, why don't we repeal the oil industry tax provisions that were enacted last year as part of the tax cut? Does not the same logic apply to them that you have just expressed—the alternative energy tax?

Secretary REGAN. No. I think I can fully explain that, Senator. What we are suggesting here is that, in these alternative forms, they have a new type of accelerated depreciation—the ACRS that the Congress passed in 1981. They did not have that in 1974-5-6, and so on, when these laws were passed. They did not have the leasing provision at that time, investment tax credits, things of that nature. Therefore, now that the tax law has changed that much and there are these added incentives there, they still have tax breaks in order to produce these alternative sources.

The oil industry? They have depletion. They are getting a tax break. So the two are equated in a way. Now, for the oil industry, we are putting in the minimum tax. As you know, the depletion actually is in the minimum tax right now for the oil industry. So we think we are putting them both on an equal footing.

Senator MITCHELL. Well, I just strongly recommend the contrary to you for reasons more than just the necessity for closing the deficit, but really for reasons of fundamental fairness. Mr. Secretary, most of the American people don't understand the details of this tax bill and tax legislation, but they do understand fundamental fairness. You must be concerned about the rising number of Americans now in the majority who believe that the administration's economic program is unfair. And for most Americans, and I will retract that and say most people in my State, because I have not traveled widely in other States, the symbol of that unfairness, the tangible manifestation of that unfairness, is when the President says, "We've got to cut taxes on the oil industry; we've got to give them a break," and it turned out to be $12 billion, and that creates a deficit. And then he comes back in next year's budget, same Government, this committee, and says, "We've got to close this deficit, so let's cut medicare, let's cut medicaid, let's cut all of those programs."

There is a fundamental unfairness there that is apparent to most of the American people. And I suggest to you that is one of the reasons why the economic program is not working. I urge you to reconsider your position in that respect. I think it will go a long way beyond the immediate dollars that are involved in closing the budget deficit.

Secretary **Regan**. Well, you have to take a look at what has happened since the decontrol of oil as to oil exploration in this country and the like, the number of wells that have been drilled, things of that nature. We are finding more and more oil in this country as a result of the incentives that were given them.

Senator **Mitchell**. Is production of oil increasing or decreasing?

Secretary **Regan**. Actual production has stayed about the same, I believe, at this point. But we are finding more and more oil in different places—not only the overthrust belt, but elsewhere. So, as a result, I think that the incentives that we have given to the oil industry are logical in view of what we have done.

Now, as far as cutting back on medicare and things of that nature, remember for these programs, again, it's cutting the rate of growth in these programs. There will be more money for medicare in 1983 than in 1982, and more in 1984 than in 1983 under our procedure. So we are not saying actually cut back, we are saying cut the rate of growth in these funds, particularly the growth in hospital costs which, I think the Senator would agree with me, are getting way out of hand at this point.

Senator **Mitchell**. It is a very severe problem, but I have to disagree completely with the approach the administration is taking to solve it. I do agree with you, it is a problem.

My time is up, and I don't want to intrude on the time of others. Thank you very much.

The **Chairman**. I just want the record to show that there is no oil produced in Maine, and that we might want to take a look at the tax breaks the timber industry gets; I think we can get into this argument all day long.

I might also say the administration did not propose the oil amendment; they came from above. [Laughter.]

Senator **Mitchell**. But they supported it.

The **Chairman**. Senator Grassley?

Senator **Grassley**. Mr. Chairman, I would like to put a statement in the record which would substitute for an opening statement that I was going to make if I had been here.

The first question I am going to ask you I will submit to you in writing, but I wanted to mention it so you would think about it. It deals with your Department and the Department of Justice. It pertains to successful challenges for attorney's fees from the IRS under the Equal Access to Justice Act. We are trying to extend this provision to the Tax Court, but there are limitations on the amount of legal fee in your budget request.

It is my feeling that congressional intent in this area is clear. I would like to ask you the extent to which you supervise the IRS—and they may have had something to do with this—and oversee budget requests. Hopefully, this request will be changed. But I will submit that to you in writing.

Senator GRASSLEY. I would like to echo the point Mr. Mitchell made, and a solution to it that Mr. Symms proposed.

I sense, after being in Iowa quite a bit since Congress adjourned before the Christmas break, that there is this perception that the tax bill was not fair. I don't agree that it is unfair, and I don't mind saying that publicly. There is a sense or perception of unfairness that it was a tax cut for the corporations and a tax cut for the wealthy, but that the little working person isn't getting a fair share. It is something that the President also faces. Fairness is so intertwined with this whole budget. The unfairness about increasing defense spending as opposed to social programs is a concern we have to realize is there. If you aren't aware of it, I'm giving you my view from my State.

I traveled a great deal in my State during the month of January and also even last week. I think the President is in the middle of explaining the equities of his plan to citizens because of his ability to communicate. I also sense that there is a reluctance on the part of White House advisers—not you, but of White House advisers—to limit the President's appearances on television and radio to avoid overexposure. The President's success last year was based upon his ability to go to the people at the grassroots and convince them that enthusiasm percolates up through the system and is gradually reflected in the Senate and House. Particularly, that was necessary in the case of the House of Representatives, and the job is even more difficult this year than last year.

So I think the President is going to have to be more aggressive in helping those of us in the Congress who basically support his view. I think it can be done, but it rests with what Senator Symms said—offsetting the liberal bias of the media. The President is our best weapon.

On a related point, how should we build confidence in the program so that the business community will react?

I feel that we have made dramatic changes, even considering the fact that the deficit is bigger than we expected. If we don't act, the deficit is going to be still bigger, and a high deficit is causing people to doubt our program, particularly the business community. The fact remains, we did make dramatic changes in budgeting and tax policies last year. And I ask, what do we have to do here to get the Fortune 500, the Wall Street people and the business community generally to respond favorably? If the whole success of supply-side economics and the Reagan program is based upon their response to this, what more can we do? And how long do we have to do it for there to be a response?

I am not asking that question in any way of chastisement, I am just looking for a straw to grasp onto.

Secretary REGAN. I think, Senator, that we will have to segment the question and also segment the answer to this extent: Let's take manufacturing companies and building new plant and equipment. The present rate—their current plans are just barely keeping up with the rate of inflation in this country.

I think that you have to think through that they probably have many plans to go ahead to expand. But when they run their figures through a computer software program, the results don't come out of the computer with the rate of return that they think they must have to start borrowing that kind of money at 17-18 percent interest. So I think that the whole key here is the rate of interest. If that rate of interest comes down, and hopefully sooner rather than later, then I think you will start to see that recovery. The Wall Street area, whether it is the buyers of securities or the sellers of securities, the lenders of money or the borrowers, I think the whole idea here is credibility. Are we going to be a credible administration? Is the Congress going to work with us in order to get these deficits down? Or are we going along year after year with ever-increasing deficits? I think if they see the trend coming down, I think then that's when confidence will be restored. I think that's when that unusual gap, that premium that we have to pay now for money, will start to shrink and, with it, interest rates.

Senator **Grassley**. Aren't they giving any consideration at all to the dramatic accomplishments that we made last year in reversing budget growth?

Secretary **Regan**. Since I have been there—I guess I will have to make a complete confession. What you are asking for is businessmen to be other than businessmen. Businessmen are designed to make profits, whether they are in the service sector, in the financial sector, or in the manufacturing sector. And if they can't see where they are going to make profits, regardless of what plan we have, they are not going to indulge in it. And they can't make profits with these high rates of interest.

Senator **Grassley**. Well, the UAW is responding to the marketplace by renegotiating contracts; Ford and General Motors are responding to the marketplace by offering rebates; when are the bankers going to offer rebates? If there is money there to loan, instead of just worrying about the profits, why can't they take some cut, too, in their profits, if General Motors and Ford can? Banking is business just like General Motors is, isn't it?

Secretary **Regan**. Well, I think you have to look at their overall blend of rates, or things of that nature, to see what their margins of profit are.

One portion of banking, that is the thrifts, as you know, have been knocked out of the market by these high rates of interest, therefore they can't help at this particular moment. The other part, the commercial banks, they are looking at the weekly fluctuations in money, what it is costing them and the like, and I think they are going like a yo-yo with this.

Senator **Grassley**. I get tired of bankers telling me that they have got plenty of money to loan but nobody wants to borrow it. Doesn't money respond to the marketplace just like cars and labor does?

Secretary **Regan**. Certainly it is supposed to, Senator.

Senator **Grassley**. Well, can't you communicate that to the bankers of this country? You know, the people that have the most to lose sometimes in our society and our economy do the least to keep it from happening. Now, those aren't my words; those are the President's. But it's true, dog-gone it. They have had 12 months to respond to a change of direction, and they aren't doing it.

Secretary **Regan**. Well I think, there, as I suggested in some of my earlier answers, it is a combination of not knowing exactly what is going to happen to the business tax cut, not knowing exactly what is going to happen to the deficits, and not knowing exactly what the Federal Reserve is going to do with some certainty.

Senator **Grassley**. Well, these people have tremendous influence on our economy—not as much as the Federal Government, but they have tremendous influence. And somebody has got to get out there in front. Otherwise you are going to go back to the pump-priming days of the New Deal, and you know where that's got us, where we are today, and we don't want to go back to that. So we have got to ask the private sector to respond.

The **Chairman**. Senator Boren?

Senator **Boren**. Mr. Secretary, following along with what Senator Grassley just said. I hope my comments will not be misinterpreted or taken as being unkind, but I do want to be candid with you. I want this administration to succeed. I have not tried to play partisan politics with it. I am very concerned that if it does not succeed that those of us on both sides of the aisle with moderate and reasonable views will see a situation in this country in which we could have a lurch far to the other direction, far to the left, that would be damaging to this country for a long time.

So what I say I don't say from a partisan viewpoint or a viewpoint of one that is basically unsympathetic of what is attempting to be done. But I think credibility is the key. And, frankly, as long as we have deficits growing at the rate they are, even if you take Mr. Stockman's figures, the optimistic figures, and you look at the fact that we have indexed our income downward in the out-years of the tax bill and we continue to index most of our benefit payments upward, we take the Stockman figures on the deficit itself, there is no one that needs a crystal ball to understand why reasonable businessmen who are looking after their own investments and are having to look down the road at what they think will happen to interest rates are guessing as they do. They are right to guess as they do.

The people of this country I think elected this administration because they expected it to balance the budget. When people talked to me last year about supporting a bipartisan movement, which I did support all the way up and down the line, they wanted to do it because they wanted to balance the budget. They think that that has been the greatest problem, that these deficits are the greatest problem we face. They have not changed their mind.

I just came from 10 town meetings in my home State—the President suggested we get out and listen—and I just want to share with you that I asked the question in 10 town meetings to crowds ranging anywhere from 50 to 200 each, relatively small towns. I said:

> How many of you would be willing to have a lesser increase in defense spending? How many of you would be willing to put off the third year of the tax cut in order to get the deficits down?

I would suppose there were 1,500–2,000 people in all those meetings put together, and 3 people said they might not be willing—out of 1,500 to 2,000. All the rest urged me to do that, and to advocate that to the administration.

So I am trying to listen to the American people. I wonder where the administration is? I am very concerned about it.

I must say to you also, candidly, that when proposals are made like that made by Senator Hollings, who said, "Let's put a freeze; let's look at entitlements; let's look at everything," a very, I think, courageous statement, "let's look at military spending; let's look at how fast we can afford tax breaks," and was branded as ridiculous by yourself and others, that that is not a bipartisan spirit.

I am convinced there is a true bipartisan majority in this Congress ready to get the deficit down and to tackle the very tough political questions that would be necessary to do it, if we could get the President to join in with that real majority that exists in this Congress on both sides of the aisle.

And I urge you, I plead with you, don't keep giving the President this advice, if indeed you are, that the deficits really are not as important as is being said by others. They are. And people are. Wall Street is reacting as anyone would who is trying to make investments and decide where interest rates are going to go. And the long-term bond market is where it is because people are making very rational calculations about what is going to happen to the rate of interest in the future, and they don't want to get caught like thrifts. I think all of us know it, and I would just preface it by saying that.

But I would like to ask this question: We are trying to get the interest rates down in the short run, and I think getting the deficit down is the only way to do it, overall. Have you considered at all the fact that mergers and what I would call nonproductive use of credits took some $61 billion last year, for example, for Du Pont to buy Coneco, for United States Steel to acquire Marathon, and so on, and this will ultimately recycle in the economy? But yet if that $61 billion could have gone more directly into productive investment—housing, and other things where we have serious need—wouldn't it have been better?

I understand President Eisenhower jawboned with the financial community when he was President, that there is authority under existing law. I believe the President could authorize the Federal Reserve to take action to establish rules about the nonproductive use of credit. It is my understanding Mr. Volcker has said that he would use such authority if authorized by the President. Is that under any consideration by the administration?

Secretary Regan. Well, if we are talking here in terms of credit allocation, I think that that, at least as far as I'm concerned, was pretty well discredited in the past.

You take the efforts as recently as March of 1980, in order to do this at a time when we had some similarities with the present situation. They didn't work, and they had to be taken off right away. I don't think that credit allocation by the Federal Government works. I may think that I'm pretty good, but I don't think that as Secretary of the Treasury I could participate in any kind of a sensible allocation of credit better than the marketplace would be doing.

Now, as far as your particular question, I would be glad to submit to the Senate and for the record a study that we have made of the recycling of some of these dollars in these mergers that shows that they don't have the disincentives that might appear on the surface.

Senator **Grassley**. I would like to see that study and I would be very interested in studying it.

[The information follows:]

Merger Activity and Bank Credit

This report was prepared in response to a request to Secretary Regan by Chairman Domenici of the Senate Committee on the Budget to provide a historic perspective on the amounts of money involved in merger activity. 1/ It provides measures of merger activity for 1981 and for previous years and documents the growing use of cash in these transactions. The impact of the use of bank credit for merger purposes is briefly analyzed.

1981 Merger Activity

Corporate mergers and acquisitions increased both in their size and in number during the first three quarters of 1981, according to data reported by W.T. Grimm & Co. 2/ There were 1,807 merger announcements during this period compared with a total of 1,889 announcements for all of 1980. Total reported payments associated with these mergers in the first nine months of 1981 amounted to $60.8 billion--about double the amount for the comparable period the year before. The total for all of 1980 was $44.3 billion.

There has also been increased activity this year with respect to large merger deals. Ninety-four of the mergers in 1981 had a reported purchase price in excess of $100 million. This is the same number that occurred during the entire previous year. In 1980 four of these transactions involved payments in excess of $1 billion. Together, the four were valued at $8.4 billion. After nine months the 1981 count of billion dollar mergers stood at eight. These eight contributed $24.3 billion or nearly 40 percent of the overall dollar total for the first nine months.

Mergers and takeovers are obviously not new phenomena, and it is doubtful whether current rates of corporate acquisition approach those of the period 1967 to 1969 in relative terms. In particular the data on merger activity are biased upward. The dollar amounts of mergers and the assets involved should be

---

1/This request was made during a Committee hearing held on October 30, 1981.

2/ W.T. Grimm & Co. collects data on net merger and acquisition announcements, defined as "completed or pending transactions as of the end of the applicable period. Grimm records publicly announced transfers of ownership of at least 10 percent of a company's assets or equity. Divisional or partial sales must have a minimum purchase price of $500,000 to be included in the merger count." W.T. Grimm & Co., 1980 Merger Summary. Data for 1981 was obtained from an October 21, 1981 news release, "Merger Upturn Persists, Third Quarter Up 25%."

adjusted to remove the effects of inflation, which account for some of the rise in merger activity over time. Also, growth of the economy would normally be expected to increase the number of firms and, hence, the trend of mergers. What is new, however, is the dramatic increase in the use of cash, rather than stock swaps, in the financing of mergers. Furthermore, at least with respect to tender offers, 3/ bank credit has apparently been an important direct source of that cash.

Historical Perspective

Table 1 reports merger announcements for the years 1973-1981. These data show a relatively high level of mergers in 1973. The number of announcements falls precipitously through 1974 and 1975 and more slowly thereafter, with a small upturn in 1979 and a more noticeable upturn in 1981. However, the data on larger mergers (in excess of $100 million) illustrate an almost exact opposite trend, increasing continuously since 1975. The number of these large merger announcements nearly tripled in 1976, almost doubled again in 1978, and are rising very rapidly in 1981. The number of mergers with payments in excess of $500 million almost tripled in 1979.

Table 2 shows the type of announcements being recorded. In recent years, about 35 percent of the announcements each year have involved a divestiture. 4/ Over 50 percent of the announcements involve the merger of closely held companies. This latter type of merger typically involves less use of cash, with a greater reliance on stock swaps. Mergers of publicly traded companies constitute roughly 10 percent of merger activity each year. Of these, less than a third are tender offers. Thus, tender offers, which account for most of the takeover headlines, represent less than four percent of total mergers.

3/ A tender offer is one means of attempted corporate acquisition by which an effort is made to purchase a controlling or majority interest in a publicly held stock, often bypassing the target firm's management.

4/ Divestitures are defined as "partial sales where 10 percent or more of a company's equity is purchased as well as divisional sales where a product line, subsidiary, or a diversion is sold." W.T. Grimm & Co., 1980 Merger Summary.

Table 1

Merger and Acquisition Announcements

Year	Total	Number of Announcements: With purchase price in excess of $100 million	Number of Announcements: With purchase price in excess of $500 million	Total Reported Payments** ($billion)
1973	4,040	n.a.	n.a.	n.a.
1974	2,861	n.a.	n.a.	n.a.
1975	2,297	14	1	11.8
1976	2,276	39	4	20.0
1977	2,224	41	2	21.9
1978	2,106	80	5	34.2
1979	2,128	83	14	43.5
1980	1,889	94	15	44.3
1981*	2,409	125	16	81.7

*Annualized numbers based on 1,809 mergers during the first nine months of the year.

**These figures should be treated with caution. A minority of total transactions typically report dollar amounts. For example, in 1979, payments data were available for 1,047 mergers, or 49 percent of the total number of transactions. In 1980, payment data were available for 47 percent of the transactions.

n.a. - Not available from sources cited.

Source: W.T. Grimm & Co., various news releases and Merger Summary, 1977, 1980.

Table 2

Merger Type

(Percent of total announcements.*)

Year	Divestiture	Privately-held Companies	Publicly Traded Companies: Total	Publicly Traded Companies: Tender Offers
1976	46	38	7	2.2
1977	45	44	[illegible]	2.6
1978	39	46	12	3.4
1979	35	49	12	3.7
1980	35	52	9	2.1
1981**	34	56	n.a.	n.a.

* A residual category not shown here includes foreign sellers.

**Percentages reflect nine months activity.

n.a. - Not available from sources cited.

Source: W.T. Grimm & Co., various news releases and _Merger Summary_, 1977, 1980.

W.T. Grimm & Co. reports that 30 percent of total announced tender offers in 1979 (as distinguished from completed or pending offers) involved bids of $75 million or more. The equivalent figure for 1980 was 35 percent. This percentage has increased dramatically since 1975 when only 7 percent of the offers were in this range. 5/ This increase is due partly to a general inflation of asset prices over the years and partly to a real move towards relatively larger takeover bids. 6/

A longer term perspective on merger and acquisition activity may be obtained from data collected by the Bureau of Economics of the Federal Trade Commission (FTC). Two series have been compiled by that agency: an overall merger series, and a large merger series that includes acquired manufacturing and mining companies with assets of $10 million or more. Data pertaining to these mergers are shown in Table 3. Unfortunately, the FTC data collection effort was discontinued after 1979 so that comparable numbers for the most recent years are not available. Also, the FTC coverage of mergers is more limited conceptually than the data reported in Table 1. 7/ The two series, therefore, are not comparable.

5/ W.T. Grimm & Co., Merger Summary, 1976, 1977, 1980.

6/ These data are not good measures of the relative growth in merger activity, as they contain an upward bias over time. First, with economic growth, the number of firms in the economy will grow and there is no reason why the number of mergers should not expand accordingly. Similarly, new economic growth, as well as inflation, should support an upward trend in asset values over time.

7/ To be included in the FTC data, an acquisition must meet four criteria:

1. The FTC must have jurisdiction over the industry to which the acquired company belongs. This excludes commercial banks, transportation entities such as railroads and airlines, and communication concerns such as radio and television stations.
2. The acquiring concern must acquire at least 10 percent of the acquired company's stock or assets.
3. The acquired company must be American.
4. The acquired company must be an independent company, a subsidiary or division of another company, or a division of a subsidiary.

Bureau of Economics, Federal Trade Commission, Statistical Report on Mergers and Acquisitions, 1979, p. 11. Whereas W.T. Grimm reports dollar figures for payments (for about half its announcements), the FTC records dollar figures for assets of large mergers only. The latter also records "compensation paid" when publicly available for large mergers.

Table 3

FTC Merger Series

	Overall Merger Series	Large Manufacturing and Mining Acquisitions		
Year	Number Completed*	Number**	Total Assets of Acquired Firms ($millions)	Assets as a Percentage of all Manufacturing and Mining Corporations
1948		4	114.4	0.10
1949		6	89.0	0.08
1950		5	186.3	0.15
1951		9	201.5	0.14
1952		16	385.3	0.22
1953		23	795.1	0.44
1954		37	1,479.0	0.81
1955		67	2,227.3	1.17
1956		53	2,110.5	1.00
1957		47	1,427.7	0.62
1958		42	1,173.1	0.50
1959		49	1,712.2	0.69
1960		51	1,734.1	0.65
1961		46	2,234.9	0.81
1962		65	2,660.7	0.91
1963		54	3,187.1	1.04
1964		73	2,576.5	0.80
1965		64	3,721.9	1.07
1966		76	4,380.2	1.13
1967		138	8,955.7	2.10
1968		174	13,759.2	2.94
1969		138	12,219.2	2.32
1970		91	6,601.1	1.14
1971		59	3,140.5	0.51
1972	2839	60	2,670.8	0.41
1973	2359	64	3,558.8	0.50
1974	1474	62	5,118.9	0.69
1975	1047	59	5,528.0	0.70
1976	1164	82	5,926.0	0.80
1977	1207	101	10,129.5	1.08
1978	1279	111	11,770.4	1.14
1979***	1214	97	16,033.6	1.36

* Partial acquisitions are not included in this total.

** Data on number of acquisitions exclude companies for which data were not publicly available. There were 589 such companies with assets of $16,950.6 million for the period 1949-1979. These assets are included in the data reported here.

*** Figures are preliminary.

Source: Bureau of Economics, Federal Trade Commission. Statistical Report on Mergers and Acquisitions, 1979. Tables 10, 15, and 16.

The final column in Table 3 reports assets of acquired manufacturing and mining firms as a percentage of assets of all manufacturing and mining corporations. This series provides a good picture of relative aggregate merger behavior over time. These data show peaks of merger activity in 1955 and 1968 and indicate that merger activity had increased from a low in 1972 to a possible peak in 1979. The W.T. Grimm data discussed earlier imply that it is likely this current series, if it had been continued, would have shown a possible dip in 1980 (due to credit controls and the recession?) with a further upturn in 1981. It is unlikely, however, that 1981 data would have approached the levels of merger activity as had occurred in the boom years of 1967 to 1969.

In 1967 to 1969, over 80 percent of the reported compensation paid for acquired manufacturing and mining companies is estimated to have been in the form of stock shares. The data in Table 4 show that this percentage has dropped precipitously to where in recent years typically over 60 percent of the compensation is paid as cash and much of the rest is in some combination of cash and stock.

Using these data, two indexes of cash merger activity have been constructed. The first is obtained by multiplying the percentage of total manufacturing and mining assets acquired by the percent of reported compensation which is purely cash. This is the "cash only" index shown in Table 4. The second index is similarly obtained, using the percent of reported compensation that is either cash or a combination of cash and stock. This index is the "cash involved" index.

These indexes show vividly the increasing importance of cash merger transactions. In the relative merger index of Table 3 (column 4), the most recent year, 1979, registers less than half the (relative) merger activity as does the peak year 1968. However, in terms of the use of cash transactions, the 1968 activity is one-third that of 1979. This indicates that the potential impact of merger activity on credit market measures has increased from historical levels.

Tender Offers

Cash has been the predominant form of payment for tender offers, especially during the seventies. Over ninety percent of the offers from 1972 to 1980 have been cash offers. 8/ The use of cash, however, need not imply the use of bank credit. Firms often utilize internal financing sources. To investigate this relationship, the Securities and Exchange Commission collected for the years 1979 and 1980 information on the source

---

8/ Douglas V. Austin, "Tender Offer Update: 1978-1979", Mergers and Acquisitions, Summer 1980, pp. 13-32.

Table 4

Compensation Paid and Cash Merger Activity

FTC Large Merger File*

Year	Total Compensation Paid ($ millions)	Cash (Percent)	Cash & Stock Combination (Percent)	Cash** Involved (Percent)	Indexes of Cash Merger Activity: Cash only#	Indexes of Cash Merger Activity: Cash involved##
1967	2,955.3	3.1	2.7	5.8	.065	.122
1968	11,894.7	10.8	5.5	16.3	.317	.479
1969	5,390.3	8.2	7.2	15.4	.190	.357
1970	3,282.0	28.6	7.5	36.1	.326	.412
1971	1,611.6	25.8	6.3	32.1	.132	.164
1972	2,070.0	21.8	5.6	27.4	.089	.112
1973	2,073.3	22.6	2.2	24.8	.113	.124
1974	3,324.2	60.8	5.5	66.3	.420	.457
1975	2,826.8	59.4	13.7	73.1	.416	.512
1976	3,530.1	64.3	6.8	71.1	.514	.569
1977	5,637.8	39.1	14.9	54.0	.422	.583
1978	7.792.8	75.2	8.8	84.0	.857	.958
1979	7,796.3	65.6	32.9	98.5	.892	1.340

* Percentages are of asset totals, excluding acquisitions for which no public data were available.

** Sum of previous two columns.

Column "Cash", this Table, multipled by final column, Table 3.

Column "Cash Involved", this Table, multiplied by final column, Table 3.

Source: Constructed from Table 27, FTC Statistical Report, 1979. Data coverage of firms and assets is quite uneven from year to year.

of funds used in successful takeover bids. Table 5 shows the results as compiled by the Congressional Research Service. In 1979, more than half of the acquiring firms resorted to some form of bank credit to finance their takeovers and nearly three-fourths of the required funds were directly bank financed. Less than four percent of the takeovers used an exchange of shares. Most of the remainder resorted to internal financing. Whether this meant a bank loan had to be resorted to for some other reason is unknown. In any case, the data show a high reliance on bank participation for financing tender offers in 1979.

The 1980 experience was somewhat different. Less than 20 percent of the estimated cost was directly bank financed, and two-thirds were financed internally. This situation primarily reflects the impact of credit controls in that year.

To some extent, an emphasis on bank credit financing may reflect depressed stock prices. If stock prices are depressed, as has been the case in recent years, takeovers become an attractive proposition. An acquiring firm will generally use bank credit to finance the takeover if the price of its own stock is depressed. However, as the economy recovers and stock prices firm up, stock swaps should revive as a means of financing takeovers.

1981 Credit Activity

Only a portion of the known merger-related loan commitments contracted in 1981 have been taken down. For example, in one six-week period in 1981, nearly $40 billion in lines of credit had been announced in connection with nonfinancial corporate mergers of U.S. firms. 9/ U.S. banks and their overseas branches were responsible for an estimated $20 to $25 billion of these commitments. Through August, however, loan drawdowns at U.S. banks associated with these merger-related commitments amounted to approximately $5.2 billion. 10/

9/ Federal Reserve Bank of New York, Quarterly Review, Autumn 1981, p. 29.

10/ Perhaps another $1.5 billion was booked at foreign branches of U.S. banks (and, as such, is not included in the usual bank credit statistics). Unpublished estimates, Banking Section, Division of Research and Statistics, Board of Governors of the Federal Reserve.

Table 5

Source of Funds Used in Successful Takeover Bids

	1979		1980	
	Number of Takeovers	Total Estimated Cost ($millions)	Number of Takeovers	Total Estimated Cost ($millions)
Total Bank Participation	44	4,009.32 c/	26	758.02 a/
Unsecured bank loans	14	2,187.03 b/	7	145.36
Unsecured bank loans plus internal financing	23	1,447.99 a/	12	506.80
Secured bank loans	7	374.30	7	105.86 a/
Internal financing only	33	1,239.42 c/	27	3,259.12 b/
100 percent in exchange of shares	3	692.80	5	352.23 b/
External, non-bank financing	1	35.00	0	0.00
Source of funds not available	3	c/	4	312.00 b/
Total	81	5,283.74 e/	57	4,329.14 d/

a/ Excludes one takeover with no cost estimate.
b/ Excludes two takeovers with no cost estimate.
c/ Excludes three takeovers with no cost estimate.
d/ Excludes five takeovers with no cost estimate.
e/ Excludes nine takeovers with no cost estimate.

Source: Compiled by CRS from information provided by the SEC.

By way of comparison, total commercial bank loans and investments outstanding in August 1981 amounted to $1.3 trillion of which nearly $350 billion were domestic commercial and industrial (C&I) loans. Between December 1980 and September 1981 there was a net change of $25 billion in these loans. The $5.2 billion figure, therefore, represents 20.8 percent of the loans made during that period. This figure is biased upward, since it assumes that none of the merger loan money obtained was repaid during the period. Nevertheless, it appears that the merger related loans were a significant, but not overbearing, component of new domestic C&I credit extensions.

Impact of Bank Credit

An informal survey of banks indicated that U.S. banks did not expect to limit credit to other customers and would fund any loan drawdowns through issues of certificates of deposit (CDs), federal funds/repurchase agreements (REPOs), or Eurodollar borrowings. 11/ This indicates that the formation of loan commitments themselves does not have an appreciable impact on bank credit behavior. The bank consortia involved have ready access to worldwide money markets, and it is likely they finance any major drawdown, in the first instance, by increasing liabilities rather than by selling assets such as Treasury bills. 12/

The impact of an actual extension of bank credit which is used to purchase stock will depend on the disposition of the sale proceeds by the former stockholders. There is a good presumption that a very high percentage of the proceeds would be reinvested. 13/ It is possible, of course, that the former stockholders would choose to purchase the very same bank liabilities used to finance the merger loan. In this case, the funds would be completely recycled with a minimum impact on interest rates for CDs, REPOs, and other money market obligations.

11/ Information obtained from Banking Section, Division of Research and Statistics, Board of Governors of the Federal Reserve Board.

12/ Banks typically face an exogenous loan demand in the short run, accepting all legitimate loan applications meeting a specified risk criterion. The loan rate may vary with the perceived riskiness of the loan, but the rate structure itself changes with the cost of bank liabilities. It is very unlikely that a drawdown of a loan commitment will lead directly to a cancellation of another loan.

13/ With institutional sellers, this percentage is likely to approach 100 percent.

Theoretically, however, there may be some small impact on bank reserves and interest rates if such credits rise substantially above normal levels. An increase in Eurodollar borrowings and nonpersonal time deposits would cause a small increase in required bank reserves. This would put upward pressure on the federal funds rate and other short-term rates. These interest rates would have to rise to levels sufficient to induce (1) a shift from demand deposits and other checkable deposits (which carry higher reserve requirements) into bank nondeposit liabilities; (2) a sale of bank-held assets (Treasury bills) that eliminates bank liabilities and their attendant required reserves; (3) a shift into nonbank REPOs, which do not carry reserve requirements; and/or (4) induce banks to increase their borrowings from the Federal Reserve, adding to the supply of available reserves. 14/ However, if loan drawdowns to finance corporate mergers vary between $3-6 billion per year, this would involve a relatively small proportion, i.e., approximately 1-2%, of total bank reserves. Requirements of this magnitude are in line with those of recent years, and should not be a major new influence on the financial system or on the level of interest rates.

The impact on the money aggregates will depend upon the size of the lending, the use to which the public puts the stock sale proceeds, and the response of the Federal Reserve. In many cases the amount of the money supply will not change because the funds loaned will be recycled within the banking system, although probably not in the same financial institutions or even in the same financial form. Any effects on M1B, therefore, are likely to be only transitory. To the extent that short-term interest rates rise, there will be an inducement for the public to shift out of M1B assets into M2 and M3 assets. In addition, to the extent banks reduce their holdings of Treasury securities, the initial impact on M3 will be ameliorated. Also, where banks utilize Eurodollar borrowings rather than CDs, the impact on M3 will be lessened.

Conclusion

The level of credit extended by domestic U.S. banks for merger related purposes is small when compared to overall bank loan and investment activity. Furthermore, the fact that the loan proceeds are used to buy investments creates the presumption that a very high percentage of the stock sale proceeds will be reinvested and, thus, effectively used to finance indirectly the original extension of credit. For these reasons, the extension of bank credit for merger related purposes is likely to have minimal effects on the cost and availability of credit. It is not likely that such loans would have more than transitory effects on interest rates, required bank reserves, and the growth of the monetary aggregates.

14/ This last result offers only a short term solution. Eventually, higher Federal Reserve borrowing will lead to either a higher discount rate, which will discourage that borrowing, or to a decrease in the nonborrowed reserves target. In either case, the borrowing acts as a short term buffer. Eventually interest rates must rise sufficiently to induce one or more of the other responses mentioned in the text.

Senator **Boren**. On the question of the all-savers certificates that were passed into law—there were very many active supporters of the concept on this committee—last year, in order to get more money into the S. & L.'s and the banks so that it could be loaned out for housing, it is my understanding that following the enactment of that provision that action was taken, I believe, by the DIDC, the commission for deregulating or for setting rules and regulations for financial institutions, which allowed a 1-percent brokerage fee to so-called bona fide brokers for the selling of all-savers certificates and which resulted, therefore, in a lot of the funds from the all-savers certificates being channeled to these financial institutions as opposed to the banks and savings and loans where they might have gone into housing more directly.

Was this the action of the DIDC? And I wonder if it was taken in open session with a formal vote so that we might know how the various members of the DIDC voted in terms of authorizing these brokerage fees and really changing somewhat the nature of the all-savers certificates.

Secretary **Regan**. Well, from the point of view of what I was asking my assistants here, whether or not that was done in an open session or not, I don't think that it was. I don't recall. I think it was done by the circulating of a memo, but I am not certain. I will check that for the record, Senator.

As far as why did we do it, you must realize that there are certain institutions in certain sections of the country that don't have as much money as in other sections of the country. A broker working to bring money from one section to another, I don't think is outside the realm of a real service being performed for a fee. Indeed, if the institutions didn't want the money, they wouldn't have to pay the brokerage fee. If they did want the money, they could get it.

Now to the extent that you would say, "Well, if the broker weren't there, would the money stay in the local community?" or what have you, you would have to say that in a surplus area such as Florida it would remain in Florida. But Florida still has a surplus, from the point of view of other States.

So I think that that didn't impede all-savers. I think the fate of all-savers depends upon the fact that it is of short duration, people don't understand it, things of that nature, more than the brokerage fee.

Senator **Boren**. I would agree with that. But for example, the Russell-Kansas Savings & Loan or the similar local savings & loans or banks, the fact that these brokerage fees were paid, which were not directly required by the bill itself, did that result in more money going into the First Federal Savings & Loan of a small town in Oklahoma, or less?

Secretary **Regan**. Well, we'd have to find out where the money came from, where the brokers got it. I doubt if many brokers, for a 1-percent fee for a small amount of money—$5-50,000, something of that nature—would have gone into Russell, or what have you, in order to extract that money. I would think they would concentrate their efforts in the Los Angeles's and Jacksonville's and other places of that nature.

Senator Boren. What about the DIDC? You said, and it was my understanding, the reason I asked the question, that this was not done in an open meeting, that it was not done by formal action, that it was done by informal staff agreement. With my experience in legislative and executive bodies, I have never participated in a committee that took votes by informal staff agreement instead of the principals actually voting. Is this standard procedure? Not only on this issue but on other very important issues involved with deregulation of our financial institutions, is this standard operating procedure?

Secretary Regan. No, that is not standard operating procedure. The DIDC meets quarterly, and we take a vote. If there is something of importance or a technical matter that wouldn't call for assembling of all the members to vote on just several minor items, there is a circulation of a document in which the pros and cons of the situation are there, and each member then votes by signature on the document.

Senator Boren. So there would have been a vote taken by signature on the document?

Secretary Regan. Oh, yes. And for the record I will submit a more correct answer.

Senator Boren. I would appreciate that.

[The information follows:]

The "ruling" is actually a staff interpretation of the Committee's rule prohibiting the payment of finders' fees for deposits subject to interest rate ceilings and was based upon a prior determination made by the Committee. All members of the Committee were aware of the proposed response to the brokerage question prior to the issuance of the determination. The determination, which was initially requested by a savings and loan association, was intended to assist all federally insured depository institutions in attracting ASC deposits.

Preliminary information indicates that only a small number of depository institutions utilize brokerage arrangements. The dollar volume of brokered ASCs as a percentage of total ASC deposits at savings and loan associations is relatively small; it is estimateed to be somewhere between three and five percent. We have seen no evidence that brokerage fees are unreasonably expensive in relation to either the services that are provided or the alternative costs of promoting ASC deposit programs. Moreover, no information has been presented to indicate that smaller local institutions have suffered in their ability to attract local funds. Nothwithstanding these initial findings; we are continuing to monitor the situation and are in a position to take appropriate action should evidence of abuse develop.

The Chairman. Mr. Secretary, I know you have been here a couple of hours, but I just need to ask a few more questions that I have been asked by members who could not be here.

Senator Durenberger would like a response. He said "I understand that the completed-contract method of accounting is used extensively by homebuilders and many small businesses. Will its repeal increase the borrowing needs and costs of doing business for these groups?" He concludes that it will and that it is hard to justify increasing housing costs at this time of high interest rates.

Secretary Regan. Concerning the completed-contract method of accounting, we are trying to solve a problem involving those who do special work for governments, whether city, State, or Federal Government, particularly defense contractors and people of that nature, who are building a project that takes 3 to 5 and maybe more years than that to complete.

We are making payments to them; by "we," I mean the various segments of government. They are taking that into account. They allocate against that payment various costs up to that period, and the difference is profit or loss before taxes. And they are taking that profit or loss into consideration as far as their reports to stockholders are concerned, and based upon that are the results on which executive bonuses are made and things of that nature.

But for tax purposes, they don't report until the final payment, and then they make a balloon payment of taxes, depending upon what costs are allocated.

So I think, to the extent that they have been profiting off Government subsidy, I think it's time, with all the other subsidies we are giving, that that be ceased.

Now, as far as homebuilders are concerned, ordinarily homebuilders work pretty quickly, and a home can be built within a year. So I doubt if many homebuilders have this particular problem.

The CHAIRMAN. I think what he was suggesting was if in fact it would impact adversely on homebuilders and small businesses.

Secretary REGAN. Well, there is also an exclusion in there of $50,000, as I recall, for small businesses.

Incidentally, Mr. Chairman, the complete description of all of these proposals, as I said, will be forthcoming to you and this committee and to the public, hopefully within a week.

The CHAIRMAN. Has the administration given any more thought—I know in the House bill last year there was some question of shortening the holding period, the capital gains holding period, from 12 months to 6 months. Have you given that any thought? You are not advocating that this year?

Secretary REGAN. We have no plans at the present time to advocate that this year.

The CHAIRMAN. It is my understanding that some, including the New York Stock Exchange, would actually profit from such a change. There would be a static loss, but they believe that the end result would be a profit, at least increase revenue to the Government.

Secretary REGAN. I argued that way, Mr. Chairman, for many years.

The CHAIRMAN. Right. Well, I think you understand what happened last year. It was a question of how the amendment was——

Secretary REGAN. I recall vividly what happened at that time.

The CHAIRMAN. Right. And I do, too. I remember what Chairman Rostenkowski told me, that he would not accept that provision, more or less.

Senator Boren mentioned the all-savers certificate. Is there any plan to extend that provision? That is about $3 billion a year; $4.2 billion for the 15-month original provision. Have you had an opportunity to make a decision on that?

Secretary REGAN. We have not come to any final conclusion, but our tentative conclusion is that there is no need to continue it; that it has not served the purpose that it was designed to do. I think there are other ways that we can work with the thrift industry to accomplish their purpose of trying to get more money into those institutions without the need for the all-savers.

The CHAIRMAN. I know there would be some, and in fact there has already been some interest in the extension of that. My point in raising it now is a matter we are going to have to consider, that it is a revenue loser. Now, maybe that in itself is not a reason to——

Secretary REGAN. Well, what we planned to do in Treasury was to wait for 6 months, to have 6-month figures in hand and then make a study of it, to make certain that we knew what we were talking about as to exactly what the effect of all-savers has been.

The CHAIRMAN. If we permit the foreign tax credit to offset the new minimum tax, many U.S. multinationals will continue to pay no U.S. income tax. And that's a matter of concern to some of us. It seems that they ought to be helping us pay for the military that protects their worldwide interests. I'm not certain what your position is on that, but it is a matter we are going to consider.

Secretary REGAN. We have taken no position on it, but we would be glad to discuss it and work with you on it.

The CHAIRMAN. All right. And I know the defense will be that it is double taxation, but it seems to me we ought to be able to mitigate or eliminate that and still not let them escape all taxes.

Secretary REGAN. Well, I think that was one of the reasons that there was such an outcry against the leasing provision, that some of the oil companies were able to use both sides.

The CHAIRMAN. The *Occidental* case, I think, really focused a lot of attention on leasing. Do you think there will be a fall off of leasing activity this week? [Laughter.]

Secretary REGAN. I know there will be, Senator. I know there is.

The CHAIRMAN. In the black lung bill, among other things, we put a provision that required reporting—not that it needed to be required; you are going to do it in any event. But as I understand, that date was January 31, and we hope to have that information soon.

Secretary REGAN. We have had a preliminary. We have looked at a quick study, but I want to wait. I think I can promise you that by the middle of March we will have the completed study. We are giving it top priority at IRS and at Tax Policy. And if we can get it there by mid-March, then we can start studying it and drawing conclusions from it.

The CHAIRMAN. Some of us, who don't understand it, probably, wonder why the Federal Reserve publishes weekly money supply numbers. Is that in the law, or is it a procedure that has been adopted? It seems to us it causes a lot of confusion. You spend the next week up until Friday worrying about what happened the last Friday, and it has an effect on interest rates, among other things, we think.

Secretary REGAN. Well, of course the real expert on that will be before this committee tomorrow, Chairman Voelker. But I might give my own opinion on that, Senator. I think it's more looking at the Sunshine Act and things of that nature, the Freedom of Information Act. This information is gathered now weekly by a regulation of the Federal Reserve. Since they have the figures, they publish them; because I think they feel that anyone could insist upon that information.

Now, as far as whether they should publish it, whether they should require it or not, there is a very large body of thought that says they shouldn't do it, that no one else does this on a weekly basis—no other nation. And the last time the finance ministers and the central bankers met, there were a lot of the foreign finance ministers that were urging me and Chairman Voelker that we not publish weekly for the simple reason that it added too much static to what was going on.

The counter-argument to that, though, is that, all right, there are going to be wild guesses, then, in the marketplace. Traders in the marketplace with big positions are not going to sit still and wonder from month to month what is happening to the money supply. They are going to try to get some type of proxy for the money supply and will be using that, whatever it is. So why not publish the figures anyway, if we have them?

I do think, and here I have been stern for quite a few years so this is not something new, that Wall Street overdoes it Friday afternoon. I wish they would all quit at noon on Friday and let those figures come out without fast action and hair-trigger phone calls in order to try to unload or add to a position depending on what's happened in the marketplace. I think there is too much sensitivity to the weekly figures.

The **Chairman**. Maybe if we reduce the holding period we will get that agreement that they close on Friday noon. They might be willing to do that.

Secretary **Regan**. Unfortunately, you are talking about two sides of the street—one in the stock area and one in the bond.

The **Chairman**. Well, Senator Bradley may have other questions, but I wanted to indicate that it is our purpose, the Senate Finance Committee, to move ahead on the President's budget and not wait. In some reports the administration's strategy is to wait until September. I think that was only a report that I haven't been able to confirm.

But it seems to me that if we can accommodate all the members who have an interest, we would like to complete all of the hearings in the next 4 to 5 weeks on revenue increases and also budget reductions and user fees and other things that we have jurisdiction of, and hopefully be in a position when you are back here on the debt-ceiling increase to have worked out a bipartisan compromise with Members of Congress that Senator Boren alluded to, and I think every Senator has alluded to, and see if we can't just put some nice economic package on to the debt ceiling increase and try to do it early this year.

It seems to me that is so important to the economy and to the interest rate problem. I know you haven't had the time to say yes or no on that, but it certainly, as you commented, is going to be an active time when the increase comes up here; there are going to be a lot of ideas floating around. It would be better if we just had one idea that we could agree on, the majority of members, and then go with it.

Secretary **Regan**. That is very interesting, Mr. Chairman, and I think you are forecasting something that has probability rather than possibility.

There is one thing as Secretary of the Treasury, though, that I wish you would do for me, as long as you are going to do something in the debt ceiling area, and that's change the Senate procedure on the debt ceiling so that the Secretary of the Treasury wouldn't have to be coming up as often, whether it is myself or one of my successors. I do think that we are playing games with the debt ceiling. In the passage of budgets, and so forth, we know that we are going to create deficits. Why drive the Secretary of the Treasury up here, hat in hand, to ask that a temporary ceiling that is now what—15 or more years old, that is about $400 billion, be raised annually? When the Senate is acting on its budget, why doesn't it just accommodate the ceiling at the same time?

The CHAIRMAN. Well, the House has adopted that procedure, and we are more a deliberative body. I guess when the Democrats were in control we didn't think that it was a good idea to do that. Now that there is a change, I think they have had a change of heart. [Laughter.]

Secretary REGAN. Well, speaking as one that is in between, I wish you would change your minds.

The CHAIRMAN. Plus, it is an opportunity to see you on a frequent basis. [Laughter.]

Secretary REGAN. Well, I can assure the Senator that I would come anyway.

The CHAIRMAN. Senator Bradley, do you have any closing words of praise for the administration. [Laughter.]

Senator BRADLEY. Thank you.

Mr. Secretary, I think that this is one of those few occasions where I actually have sat through the whole meeting. I did that because I wanted to see the range of people's opinions. You find, after they come back from a break, they have their speeches pretty well honed. And I have frankly found some of the things they've said rather interesting.

My own suggestion to you is that you listen to what many Members either intimated or said directly today, everyone from Senator Grassley saying, is it business that is sabotaging this whole effort, to other Senators who are interested in specific provisions, to my own concern that you not be ideologically rigid in these matters.

You know, I think we have to agree that when Senator Baker said this was a riverboat gamble, that from the standpoint of the Congress that is exactly how we felt. And I know that it was the contention of the administration that if you passed these big tax cuts that that will drive very deep cuts in spending. I think you ought to reevaluate that. I mean, Congress, as Senator Grassley said, cut $130 billion last year, and we are willing to cut some more this year. But it has to be a balanced kind of approach.

I think Senator Long's comment could be stated another way; and that is, don't send confusing messages. And probably the most confusing message that is being sent by the administration today is that deficits don't create inflation. I know I saw your chart, and I saw the declining deficits and the rising interest rates, and so forth, but the fact of the matter is that most politicians, certainly Republicans but also many Democrats, for a number of years have been telling the American people that higher deficits cause inflation. And, as you said last year, you just can't turn around that big ship in a very short distance. So my fear is that that is going to drive people's expectations and therefore determine their economic decisionmaking, and have a long-term impact that will be detrimental to the success of the program and therefore to the country.

Finally, I actually did have a question, and that is: I'm interested to see your proposals on the repeal of various tax expenditures. And I'm curious why you didn't go further. You might have seen Martin Feldstein's article in the Wall Street Journal just this week. He recommended eliminating a number of other so-called loopholes, tax expenditures, and I'm curious whether part of the administration's flexibility is a willingness to consider many more of these?

Secretary REGAN. As I said in my prepared testimony, Senator, we are more than willing to work with this committee and with Ways and Means to see what the wishes of the committee are in this area, as long as they don't interfere with and become disincentives to what we already have in place in both the business and in the individual tax cuts.

Senator BRADLEY. Because I think what you heard here, at least from Senator Heinz and a couple of other people, is that you've endorsed the idea of a minimum tax that affects all corporations, and yet you haven't been very agressive on the idea of the tax preferences. I mean, you have come up with $7 billion, which is better than nothing, but I think there is a certain wish that the administration would kind of take the lead here even more than it has.

Secretary REGAN. Well, I don't think we want to go overboard on these and wipe out entirely what we did last year with ACRS and the individual cuts. And that's why we have suggested these. If there are replacements for what we have suggested, or if there are better ones, we would certainly be willing to discuss it.

Senator BRADLEY. Thank you very much.

The CHAIRMAN. Senator Bradley, I might say we have the Joint Tax Committee and the Finance Committee staff reviewing all tax expenditures. They have been doing it for a number of weeks. And we may have some suggestions in certain areas, and certainly we expect to work with Treasury on that.

Mr. Secretary, we thank you very much.

Secretary REGAN. Thank you, Mr. Chairman.

The CHAIRMAN. It may be necessary for you to come back again, but we appreciate your testimony and look forward to working with you.

Secretary REGAN. Thank you, Mr. Chairman.

[Whereupon, at 1:18 p.m., the hearing was concluded.]

ADMINISTRATION'S FISCAL YEAR 1983 BUDGET PROPOSAL

WEDNESDAY, FEBRUARY 24, 1982

U.S. Senate,
Committee on Finance,
Washington, D.C.

The committee met, pursuant to notice, at 9:44 a.m., in room 2221, Dirksen Senate Office Building, Hon. Robert Dole (chairman) presiding.

Present: Senators Dole, Danforth, Grassley, Roth, Symms, Bentsen, Bradley, Moynihan, Mitchell, Boren, Baucus, and Byrd.

Senator **Roth**. I've been informed that the chairman has been temporarily delayed, but should be here any minute. And he has requested that I open the proceeding.

So we are, indeed, pleased to have before us today Hon. Paul Volcker, Chairman, Board of Governors of the Federal Reserve System. Mr. Volcker, we appreciate your being here today and we would ask you to proceed.

STATEMENT OF HON. PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. **Volcker**. Senator Roth, I have a statement which bears a certain resemblance to a statement that I delivered yesterday to the Ways and Means Committee, and perhaps I can just summarize some of the points as a method of getting started.

As you know, we are in difficult economic circumstances; we are in the midst of a recession. At the same time, I would want to emphasize that we are making progress on inflation. I think that is fundamentally important. It's important because of its implications for the trend in interest rates over time, which is important for the business situation as well as for its own sake. The more progress we make on inflation, the more room we are going to have for growth in this economy. We have to keep very much in our minds that part of the process of dealing with our very evident economic problems is dealing with inflation, which, of course, we have been trying to do. We now see early signs of progress on that track. I think that suggests we are beginning to lay the groundwork for a sustained recovery. It is at least as important that that recovery be solid and sustained in precisely the month or quarter in which it begins.

Monetary policy, of course, is directed in large part toward dealing with the inflation problem. It will continue to be so. I review in my statement, very briefly, some of the objectives for monetary policy last year and state our targets for this year. I make the point that I think they are consistent with recovery in the economy. I think it is also going to be a tight fit by design, because our monetary targets are designed to keep pressure on reducing inflation for the reasons I suggested.

Interest rates are certainly a key to the speed and rapidity of recovery. In that connection, I would point out that—as you know—there has been a very heavy burden on monetary policy in dealing with the inflationary situation That, in itself, has repercussions on financial markets, on interest rates. I think it is always in our interest—and I use "our" broadly, not just to mean the Federal Reserve—that too much of the burden not be left on monetary policy alone in dealing with that situation.

That, of course, brings me to the immediate concern of your committee, the fiscal situation that we face. It is sometimes confusing to describe that situation because of the variety of numbers and projections that are out. I take off from the projections of the administration or the CBO or the many private forecasters that are all in the same area as to what the outlook would be if no action were taken—if we just accept the budget and budgetary trends as given, and assume the defense program of the proportions the administration has been proposing. I think all analysts are basically in agreement that we then face the prospect of widening deficits, and substantially widening deficits, as recovery proceeds. That is an unusual and potentially alarming situation. We haven't been in that situation where, assuming a good recovery, assuming lower unemployment, assuming the revenues you get from recovery, assuming lower unemployment compensation payments, we have a rapidly widening deficit even so. That is the problem to which I think the Congress has to address itself, because it does have the potential for absorbing far too much of our savings potential for squeezing out the very investment activity and the housing, that we want to see during this recovery period.

Though the administration has clearly recognized that problem and has proposed a very sizable program for 1983, 1984, and the years beyond to deal with the budgetary situation; their proposals for reduction in the deficit are in the magnitude of about $55 billion for fiscal 1983 and $82 billion for fiscal 1984. And if a program of that magnitude were to be enacted and carried through, then you would move the deficit curve down a bit instead of having these sharply rising figures as recovery proceeds. Whether that's enough or not is a matter of judgment. I've expressed the opinion on a number of occasions that I would prefer to see a greater safety margin. The key here, in my mind, is really 1984, when the recovery has had a lot of time to proceed. What kind of a problem are you potentially looking at for that year and that kind of prospective? I think the administration has proposed a very sizable program. The challenge is before the Congress to move on that program or to present a program of comparable magnitude or larger. I think the larger that program is, the safer we will be, in terms of repercussions in the financial markets, in dealing with the problems that are so evident now.

The only other point I would make is that I think we are not just dealing with a potential problem for 1983 or 1984, but for today.

Financial markets look ahead; they look at what the prospects are for 1983 or 1984 and react today in the light of those prospects. You can strike a blow for better conditions in financial markets, enhancing the prospects for early recovery, by acting as soon and as forceably as you can to deal with those future deficits. I am not so much concerned about the deficit for fiscal 1982, the current fiscal year—which is in the neighborhood of $100 billion. That deficit very largely does reflect the immediate repercussions of the recession. It is the future deficits that loom large in my mind and large in the minds of those in the market as they have to make their lending and investment decisions.

That's a broad summary of my statement, Mr. Roth.

Senator ROTH. Mr. Volcker, it has been said that a 1-percent increase in the gross national product will increase revenues of the Government roughly $30–35 billion. That a decrease in unemployment of 1 percent will increase revenues of the Government roughly $25–30 billion. Little is said about getting the economy to grow again. Do you agree with those figures? Some people say well, we work so hard to cut spending—it is difficult to accomplish, particularly, short-range, and that we are losing sight that some growth in the economy will have a far more significant impact.

Mr. VOLCKER. I agree with the second figure you cited. I just don't have in mind the relationship regarding the first figure. It may be correct. But I think this goes precisely to the point that I was trying to make. The kind of projections that you have before you, whether you look at the administration's or the CBO's, assume an increase in the gross national product. They assume a declining rate of unemployment of what seems to me a reasonable level. These are more in the nature of projections and assumptions, perhaps, than forecasts. But they do make that assumption that you are going to get the gain in revenue and the decline in expenditure of which you speak, as you look ahead into 1983 and 1984. The hard fact that stands out after you do that exercise in projection is that even so, the deficits will rise to historically high levels. That is the problem; even after taking credit for the very facts that you mentioned, you are left with this very large deficit. We wouldn't have any problem if these deficits disappeared as the economy recovered. That ought to be our objective, but that is not the way things stand at the moment without any action by the Congress.

Senator ROTH. Well, as you know, most people feel very strongly that the high interest rates are standing in the way of recovery. Many people feel that the interest rates being charged by the banks of something like cost of living plus 8 percent is obscene. The suggestion has been made in the Halls of Congress that we ought to have some kind of maybe what you might call a windfall profits tax on these high interest rates to the extent they exceed inflation plus 3 percent.

For example, I showed you a little earlier, an article in the New York Times showing that the rate of return for the last quarter has been extraordinarily high. For First Chicago, the percent change in their operating earnings, over 80, was 200 percent; City Corp., 125 percent; Chase Manhattan, 89 percent. What would be your views of trying to level some kind of a tax on interest rates beyond a fair return, say 3 percent or so over inflation?

Mr. VOLCKER. Let me address myself to those profit figures that you quoted, first, to put them in a little prospective. The fourth quarter profit figures were, I think, good for most banks. The first figures that you have compare them with not such good profit figures for the fourth quarter of a year ago. If you look at the profits for the year as a whole, they were up for the major banks. But in relation to their assets, I don't think the profit picture of banks has been extraordinary in 1981 or relative to earlier years. They certainly have been doing better than some other sectors of the economy recently; I don't think that there is any question about that.

In terms of putting on an excess interest tax instead of an excess profits tax, I saw that idea for the first time yesterday, and I wouldn't pretend that I have sat down and analyzed it, but it is very hard for me to see how that is a workable proposition. Who do you put the tax on? Do you put the tax on the homeowner? Or the consumer who owns money market certificates or has deposits or the equivalent of deposits in money market funds? Is that who we are talking about taxing?

Senator ROTH. I think I am talking about the large banks.

Mr. VOLCKER. Then I suppose you are talking about an excess profits tax on banks.

Senator ROTH. That's right.

Mr. VOLCKER. I am not sure that you can make a strong case that there are excess profits in banks. As a banking regulator, I have to be concerned about the capital position and the strength of the bank too. Banks had a good fourth quarter—most banks, not all of them—I don't want to deny that. But if you thought of an excess profit tax in reference to some base period, some return on assets over a period of time, I don't think you would find much excess profits there.

Senator ROTH. Let me ask you this question. My time is up and the chairman is here. But is there any—do you feel that as a general proposition that it is fair to say tha a bank is receiving a good return on the cost of living plus 2½ to 3 percent?

Mr. VOLCKER. I don't think you can put it that way in terms of a bank. The bank has to look at its return in relation to what it pays. I think you can say that the level of market rates is high relative to the current cost of living. That point has been made over and over again. I would note that in looking at history, there is not the degree of stability in that relationship that some of these comments imply. In particular, I think it is not realistic to think the interest rate is going to follow the consumer price index on a monthly basis or a quarterly basis or even an annual basis. That is not the way it has worked historically. I agree with the general point that there should be some tendency over a period of time for interest rates to bear some relationship, on the average, to the inflation rate, presumably being above it. But there have been long periods in history where it was below it and real interest rates were negative. There have been periods in history where it was above. We are in a period now where, I believe, the inflation rate is declining. But we have come off a period of very high inflation rates and I think it is fair to say that the market is not entirely convinced; it is not as confident as I would like to see it about the future prospects for inflation. I think, perhaps, the market is underestimating the progress we are going to make on inflation. There's a lot of caution in the market, based upon the fact that looking back over the last 15 years the trend has been in the other direction. In that sense, I suppose, they are sort of from Missouri, if I may use that expression; they still need some convincing. It's very important, in terms of our own policies and in terms of fiscal policy, that we continue to demonstrate that the prospects are, indeed, toward a lower rate of inflation.

When you talk about a real interest rate, what you really have in mind is the interest rate prevailing in the market relative to what people think the inflation rate will be in the future, not to what it was last month. One way of expressing our objective is to be convincing enough about the inflation rate and have it come around that you will have these interest rates decline. These interest rates are very high; partly for that reason, I don't accept at all the proposition that interest rates have to rise as economic recovery proceeds. We are starting with a very high level of interest rates, and if we can get a recovery going consistent with the decline in the inflation rate—and I think we must; that's the only way the recovery is going to be sustained—I think we can look toward interest rates declining for a long period of time, with that in itself helping to keep the recovery going.

Senator **Roth**. I would hope that your statement would allay some of the concerns. And I appreciate your concerns.

Thank you. Mr. Chairman.

The **Chairman**. Senator Byrd. [No response.]

Senator Moynihan.

Senator **Moynihan**. Thank you, Mr. Chairman. Mr. Volcker, you have heard from Senator Roth a proposition which is gaining some support on the Republican side that there should be a windfall profits tax on major banks. And this follows a succession of years in which the other side was exceptionally confident that if there could be a huge reduction in tax rates, there would be no loss of revenues. In other words, no deficits. In other words, no anticipated huge levels of Federal borrowing or higher rates of interest.

The degree of economic confidence which is shown on the other side with respect to equal and opposite propositions, is getting to be part of our economic problems. But we will ask the banks how they like the Republican proposal. I will ask you, as the biggest banker in the country, is it your intention to keep interest rates at these extraordinary levels throughout this recession? Now we had what was called "good news" yesterday. In the middle of the worst recession since the 1930's, the prime rate dropped to 16.5 percent.

I think it is a fact that in 1777, with the British occupying New York and Burgoyne headed for Albany and the South in the hands of the British, the Continental Congress issued bonds at 6 percent. The market is now charging, I think, 12 percent for 90 days. Are you going to keep these rates this extraordinarily high? When was the last time the Federal Reserve changed its rates?

Mr. **Volcker**. You have got the Federal Reserve charging this rate.

Senator **Moynihan**. No.

Mr. **Volcker**. I think the market is charging these rates.

Senator MOYNIHAN. Your money supply, to some degree, is intended to affect the rate.

Mr. VOLCKER. My money supply? The money supply has some influence, but that's a complex influence.

Senator MOYNIHAN. Some influence, sir.

Mr. VOLCKER. What?

Senator MOYNIHAN. Well, surely you have a plan. You don't always succeed.

Mr. VOLCKER. We have a plan with respect to the money supply.

Senator MOYNIHAN. Yes.

Mr. VOLCKER. But that's different from having a plan with respect to interest rates.

Senator MOYNIHAN. You have no plan with respect to interest rates?

Mr. VOLCKER. We don't have a specific plan with respect to interest rates. I would think, as I suggested in my answer to Senator Roth, that the most powerful influence in bringing down interest rates over a period of time will be the prospects for inflation, and our policy is certainly directed toward encouraging a decline in inflation. I think that that is, in the end, fundamentally important to the outlook for interest rates.

There are other factors that affect interest rates as well, certainly in the short-run. There is a lot of pressure on monetary policy with respect to dealing with inflation in the short-run. There is not a large supply of money out there relative to economic activity, and that tends to put pressure on interest rates. The fiscal position aggravates that effect. There is something you can do about those interest rates.

Senator MOYNIHAN. Let me ask you a question to get on the record what I think is the case. Surely of all the branches of the American Government, this fourth branch, the Federal Reserve, is the least understood. And its policy decisions, while open, are not comprehended very readily. Is it not the case that about 2 years ago, you switched your main object from controlling interest rates to controlling money supply? That there was a conceptual change in the way you went about your work?

Mr. VOLCKER. No. I think that overstates it in th sense that before October 1979 we were also looking at the money supply. We had money supply targets. The Humphrey-Hawkins Act requires that we have such targets and that we present them to the Congress. That procedure and the intent of a money supply target was not changed. What was changed was the approach by which we attempt to reach that target; we now operate much more directly through reserves and the reserve base and their relationship to the money supply, where as we used to operate directly on the Federal funds rates in the short run. However, the operation on the Federal funds rates in the short run was designed to affect the money supply over a period of time, so that objective has not changed.

You referred to the complexity and the difficulty of understanding what the Federal Reserve was about.

Senator MOYNIHAN. We have all followed perfectly what you just said.

Mr. VOLCKER. These things get difficult, but in effect, we're tried to simplify that. Let me make the point this way: The basis of our operation—before 1979, but perhaps more clearly after 1979—is to work on what is a fairly simple and I would hope comprehensible relationship. Too much money means inflation. If you are going to deal with inflation, you have got to bring down money growth.

Senator MOYNIHAN. Would you be willing to predict what the prime rate of interest will be at the end of 1982?

Mr. VOLCKER. No. Because I religiously refrain from such projections. People might attach some importance to them.

Senator MOYNIHAN. If someone said it will not be much below what it is now, would you think them wrong?

Mr. VOLCKER. You are not going to lure me into a precise prediction of that sort. I will say, as I have said, that I think these interest rates are extraordinarily high relative to the current inflation rate. Our policies are aimed at reducing that inflation rate. Over a period of time, I would expect those interest rates to decline and to decline even with business recovery, but just how much time that will take on a direct path to interest rates during this period ahead, I don't want to try to be precise about.

I know certain things that will speed that. I think it is essential in the background—or in the foreground, if you will—that there not be any doubt about our own intentions about persisting in the fight on inflation. Right now, one of the major preoccupations in the market is the budgetary situation, and if you want to strike a blow for speeding and insuring and reassuring a decline in interest rates, then I think you want to deal with that budgetary situation, because it is another major element in our financial market picture today and one of the reasons why markets have been hesitant, as you suggest in the midst of a recession, in terms of interest rates being held at these levels.

Senator MOYNIHAN. Thank you very much.

The CHAIRMAN. Senator Danforth.

Senator DANFORTH. Mr. Volcker, if our main concern in the Congress is to try to get interest rates down as far as we can as fast as we can, what would you advise us to do?

Mr. VOLCKER. Then you go as fast as you can and as large as you can in dealing with the budget deficit, prospective budget deficit. Again, I am not so concerned about 1982.

Senator DANFORTH. Now, I thought, there was some confusion in Secretary Regan's testimony yesterday as to whether or not there is a relationship between the budget deficit and interest rates. I take it your view is that there clearly is a relationship between the budget deficit and interest rates?

Mr. VOLCKER. Yes. My view is there is a relationship. But let me define that relationship. If you look at history, at a time series of deficits and interest rates, you will probably find a correlation in the opposite direction; that is the bigger the deficit, the lower the interest rates that appear on the surface. You might want to leap to a conclusion that you should have a bigger deficit to get interest rates down. Well, what you see in just that simple correlation over time is that deficits tend to be bigger when the economy is in recession or most sluggish; you have very powerful forces, ordinarily in a recession, to push interest rates down, and some of those same forces push the budget into deficit. So you see, on the surface, there isn't much relationship.

We have a situation here, as I tried to emphasize earlier, which, left unattended, would produce a very large deficit in a period of prosperity. What does that mean? That means that the Federal Government would be preempting a very sizable share of the potential savings of the economy, or a historically large share of the total amount of credit available, and I think that does put pressure on interest rates.

Senator DANFORTH. Well, Secretary Regan's testimony was that while the Federal deficit is very high, private savings are going to increase at a rate faster than the deficit. Therefore, the ratio between savings and the deficit will continue to go up, and there isn't any problem in financing the deficit.

Mr. VOLCKER. I would agree the probability is and my own expectation would be, that the savings rate is going to go up as the economy expands. It has been extraordinarily low. You have taken some tax measures to encourage savings, but the prospects for inflation itself—indeed, the level of interest rates, all encourage savings. I would expect to see savings rise. That's a matter of proportion. We are starting right now from a situation in which certain private credit demands, anyway, are depressed. That is particularly true in the homebuilding, home buying industry. It is an enormous user of credit when it is operating at a high level. So we have got to make room for what we want to see.

Senator DANFORTH. As I understand it, your view is that regardless of Secretary Regan's testimony yesterday with respect to any increase in private savings, still, it is very important for the Congress to get to work on the deficit and to close the deficit.

Mr. VOLCKER. Well, I suspect, first of all, that Secretary Regan was referring to projections, prognostications, assuming that the President's program is enacted.

Senator DANFORTH. Yes.

Mr. VOLCKER. I am now talking about a deficit before the President's program is enacted—that $150, $160, $170 billion deficit that is staring you in the face in 1983, 1984, 1985. Obviously, if you do what the President is suggesting and enact a program on that order of magnitude, you have taken a very big chunk out of the problem. As I said earlier, I would feel more comfortable if you went beyond that. If you want to make a striking impact on the financial markets, the more you do, the better off we are going to be.

Senator DANFORTH. Do you think that we should amend what we did on the tax bill last year?

Mr. VOLCKER. I might say, in general, that I am very reluctant to get into the composition of what you might do. I think my only appropriate role is to suggest the nature of the overall problem. You get into a lot of other considerations when you ask which expenditure, which tax.

Senator DANFORTH. Secretary Regan took the position yesterday that we should reduce spending but we should not reduce or delay the tax cut. He felt that there is a very big difference between closing the deficit on the spending side and closing the deficit on the revenue side. My suspicion is that if we want to take really bold action on the deficit, we can't leave out half of the problem and that we are going to have to look at the revenue side. Would you say that that is true?

Mr. **Volcker**. My position on that is very simple, Senator. I think from an economic standpoint it is better to do it on the expenditure two side. I am not looking at social objectives, I'm not looking at defense; those things are all important. I'm just giving you strictly an economic judgment for the health of the overall economy. You would be better off doing it on the spending side, and I would urge you to do all you can on the spending side. If you can't get it all done on the spending side, then I think you have got to come around and look at revenues, but that doesn't necessarily mean looking at the income tax or the business tax provisions that you enacted last year. There are other sources of revenue. You can look at so-called loophole closing for what that is worth, and you can look at other areas of taxation too. There are areas of excise taxation for instance; there are areas of energy taxation where choices can be made. I don't think anything I say necessarily says you have to look specifically at what was done last year, at that tax program, which was designed to produce certain favorable incentives.

The **Chairman**. Senator Bradley.

Senator **Bradley**. Thank you, Mr. Chairman. Mr. Volcker, it seems that what you are saying is that the sooner we get the deficit down, the more likely it is that interest rates will come down.

Mr. **Volcker**. Yes.

Senator **Bradley**. But have you given us any assurance that interest rates will come down if the deficit is reduced even more that the President's projected target?

Mr. **Volcker**. All I can give, I guess, is a commitment as to how the market is going to react. I can give you a judgment that if the market were convinced that the deficits were going to progressively decline significantly below the $100 billion level that we are starting with this year, I think that would be an extremely constructive element in market thinking and would be reflected, particularly, in long-term rates.

Senator **Bradley**. As we struggle with this question, we have the President's proposal of roughly $26 billion in nondefense cuts, $20 billion in so-called management efficiencies, and $9 billion in tax increases in the form of loophole closing——

Mr. **Volcker**. You are looking at 1983?

Senator **Bradley**. 1983. That's the target. That comes to roughly $54 billion. We are also, as you said, in a recession. Hopefully, it will bottom out by summer, but one can't be absolutely certain. And there are rather ominous signs out there like the productivity decline in the last 2 or 3 months of 1981. Normal economic analysis would say that if you are in this kind of recession, the tax cut that we have already passed, which goes into effect in July, basically, will help consumption; will help the economy respond.

In 1983, the tax cut is worth $37 billion. The third year of the tax cut goes into effect in July of 1983,. So, that there is only one quarter in fiscal 1983, which is worth $9 billion.

Now, what I am trying to assess what would get the economy moving and get the deficit down deeper. Let's say we take a $54 billion figure as given—and there will be disagreement on this committee and in the Congress about what the composition of that is. Would a deferral or a cancellation of the tax cuts that are supposed to go into effect this July be a sufficient message that the deficit is now not going to be reduced $54 billion, that instead it's going to be reduced roughly $90 billion? So, depending on whose assumptions you have, the deficit would be $60 billion in 1983, not $90 billion, or $55 billion, not $90 billion. Would that act be more stimulative to the economy and get interest rates down quicker, in your view, than would the tax cut given as a consumption lead tax cut?

Mr. **Volcker**. If you took that strong budgetary action, I think that would have a favorable effect on interest rates, all right, and you would get the stimulating effect from that direction.

I'm not sure you have to go that fast. I wouldn't suggest that. You have emphasized 1983, and that is, obviously, the budget that is immediately before you. But let me emphasize, if I can, the years beyond 1983, which in some sense are even more important. Right now, in 1982, while you have a $100 billion deficit, a very large component of that is cyclical. The structural deficit is not so big in 1982. The structural deficit gets bigger each year thereafter, and it is not going to be as big in 1983 as it is in 1984, or as big in 1984 as it is in 1985 as things now stand. But I am not sure you have to go quite as fast as you are now suggesting.

I think it is important in the budgetary actions that you take in 1983, that you look through to their effect on 1984 and 1985, because that is where the problem is potentially even more acute than in 1983.

Senator **Bradley**. We have three choices if we are going to try to affect those 3 years: One is entitlements; two is clearly defense spending which mushrooms in the outyears; and three is the revenue side—the taxes, the tax cuts that were passed last year. Particularly, the growing revenue loss from the depreciation change. Now what's your suggestion as to how we look at those three?

Mr. **Volcker**. What I am implicitly suggesting is that I don't see the need to look at that tax cut that is coming up in just a few months. Considering that we are in recession, the main deficit to be worried about is progressively in 1983, 1984, and 1985, so you have time to deal with it.

Senator **Bradley**. So, that what you are saying is that not only will 1982 not make a difference, but 1983 doesn't make much of a difference either.

Mr. **Volcker**. Everything is relative. But 1983, in and of itself, doesn't seem to me as critical as making sure that you get the thing on a path in 1983 and beyond that. I am not saying sit here and do nothing about 1983. You have got a $54 billion program of reductions in front of you.

Senator **Bradley**. But you said you would like to see even more than that.

Mr. **Volcker**. I wouldn't be unhappy to see more than that. But my focus, again—where I would particularly like to see more—is more of an implication for 1984.

I am interested in getting a pattern for the budget that will show a declining rate of deficits as the economy improves. In 1983, you are still going to have a lot of unemployment excess capacity because the economy will be coming out of recession, hopefully—I expect it will be coming out of recession. But 1983 is not as pressing a problem as is making sure you have dealt with the 1984 or 1985 proposals. I'm assuming that you do at least as much as the President is proposing for 1983.

The **CHAIRMAN**. Senator Mitchell and then Senator Bentsen and Senator Grassley.

Senator **MITCHELL**. Mr. Chairman, you have expressed the need for concern about 1984-85 and to establish a path. Is there anyway that that can be done with the indexing provisions scheduled to take effect in 1985?

Mr. **VOLCKER**. I suppose that makes it harder, but, yes, it can be done. You just have to look at expenditures and other sources of revenues. You have indexed taxes—that was not an idea that I originated—but you can live within that constraint, sure.

Senator **MITCHELL**. Do you think we should repeal the indexing provision now scheduled to take effect in 1985?

Mr. **VOLCKER**. I would like to get the economy back on a basis where price stability is a normal presumption and the issue of that indexing wouldn't even arise.

Senator **MITCHELL**. It doesn't now appear to be the case, though, and your urging of action to set a path for the future, your concern for the future, seems to me, to lead inevitably to the urging of repealing that.

Mr. **VOLCKER**. That's one thing you can look at, but I don't believe it is true that that is an absolute prerequisite; it is obviously something you can look at, but that only phases in, in 1985.

Senator **MITCHELL**. But there's a wide range between an absolute direction and something you can look at. What I am asking is what you recommend. If you were here now and someone proposed repealing indexing scheduled to take effect in 1985, how would you vote?

The **CHAIRMAN**. I'd vote "no."

Senator **MITCHELL**. Thank you, Mr. Chairman. My questioning of you will follow.

Mr. **VOLCKER**. I will give you a straightforward answer to that. I don't think that should be the source of debate right now because it doesn't take effect until 1985, and I think you are going to have to do something before 1985. That's irrelevant to 1983-84; it becomes relevant, obviously, after 1985, but you have got a couple of years before you have got to look at that one.

Senator **MITCHELL**. You used the phrase a couple of times "you have to deal with the budget deficit, deal with the budgetary situation." Let me ask you another specific question. Should we support the President's budget as proposed which contemplates a $91.5 billion deficit for 1983?

Mr. **VOLCKER**. That would sure leave you a lot better off than where you are now. I feel if that were enacted tomorrow, so to speak, and the markets knew that that was in place, you would have an improved situation.

Senator **MITCHELL**. In other words, the deficits projected by the President are acceptable to you?

Mr. **VOLCKER**. I don't think it is a question of being acceptable or unacceptable. What I said was that I would feel more comfortable with more margin, particularly as the years progress. I would feel more comfortable, particularly, if the reasonably projected deficit for 1984, assuming the same business picture, were significantly lower than he has projected for 1984 and if it were somewhat lower in 1983.

I think the job becomes progressively greater as the time period is extended.

Senator **Mitchell**. Well, he has projected deficits of $92, $83, and $73 billion in 1983, 1984, and 1985.

Mr. **Volcker**. We are all making judgments. Even if you assume the President's program, which is a long distance from where you are now, I think we would be much safer, better off, if we could look forward to lower deficits in 1984 and 1985—and to some extent in 1983 as well.

Senator **Mitchell**. At what point, in terms of the size of the deficit, is the Federal Reserve Board likely to respond and loosen the money supply?

Mr. **Volcker**. I'd put that question a different way. The more pressure taken off the markets through these budgetary actions, the more easily the economy will live with the present projection of the money supply; in other words, not so much of that available finance would be diverted to the Federal Government so that the private sector—housing, small business, farmers, business investment—will have more room to grow and expand, which seems to me the object.

I don't think we can afford to abandon the effort against inflation through monetary policy, while at the same time you are moving toward fiscal discipline.

Senator **Mitchell**. Right.

Mr. **Volcker**. We have to maintain an appropriate monetary policy at the same time.

Senator **Mitchell**. Agreed. But as you have made clear many times, in your public statements, the restrictive monetary policy is made all the more necessary because of the fiscal policy.

Mr. **Volcker**. I don't know if I have said quite that, Senator. What I said is that it is all the more difficult to live with in some sense when fiscal deficits are very large. But it is necessary, I think, whatever you start on the fiscal side. It just becomes much easier to live with when the Federal Government itself isn't preempting.

Senator **Mitchell**. Are you saying that it doesn't make any difference with respect to the deficit what your course of action would be? I guess I misunderstood what you have been saying all these months.

Mr. **Volcker**. Saying it doesn't make any difference, I think, is going too far. We have to maintain restraint on the growth of money, I think, whatever the deficit is. Let's not get that down to the last decimal point, but the general concept still holds: With too much money, you are going to have inflation, and we would undercut what you are doing on the fiscal side if we conducted an inflationary policy. We don't intend to do that.

Given that, the implications for interest rates, the implications for the economy will be quite different, depending upon what fiscal action you take.

Senator **Mitchell**. Well, if I understand what you are saying is—it doesn't make any difference what we do with the deficit, you are not going to loosen the money.

Mr. **Volcker**. That's right. We are going to maintain a restraint on the money supply that we think is appropriate to dealing with the long-term continuing threat of inflation. Obviously, we are also permitting money growth consistent with the growth of the economy under those conditions. We will continue to do that.

Senator **Mitchell**. Thank you.

The **Chairman**. Senator Bentsen.

Senator **Bentsen**. Mr. Volcker, you have been talking about the Congress cutting the steps, and I agree we should do that. But Congress alone is not at fault; the cause of a substantial amount of that deficit rests at your door. Your overrestrictive tight money policy, which keeps interest rates at these record high levels, causes unemployment. And for every 1 percent increase in unemployment, the deficit increases some $25 billion. Since last July, unemployment in this country has increased almost 2 percent. So almost $50 billion of this deficit comes because of your policies.

Last year, we saw the biggest increase in the number of small business bankruptcies in the history of our country. Last month, that was repeated again. And yet the small business sector employs far more people than big business. Thus, the effects of your tight money policy have contributed substantially to the deficit we face.

Getting down to specifics, last year you estimated that you were going to increase M_1 by 3½ to 6 percent but it actually increased only 2.2 percent. In the second and third quarter you actually contracted the money supply, while in the fourth quarter you increased it approximately 12 percent.

What I would like to ask of you, Mr. Volcker, was that by intent—is that the way you intended it to come out? Or was it because you did not have the mechanical means to control the money supply more within your targets?

Mr. **Volcker**. If I may make just one preliminary point on the deficit, then I will answer your question. You emphasized the importance of unemployment, recession on the deficit. That's true this year. But let me just emphasize again that when you are looking out there at 1984 or 1985, you are looking at deficits that assume no recession and assume a high level of business activity. That's quite a different situation. I just want to point out that that is my concern, not this year's deficit. It's the deficit that you would have even in a situation of prosperity.

Senator **Bentsen**. My concern is how you handle the money supply and what the supply was—I don't want that extrapolated into the future.

Mr. **Volcker**. Let me turn to the money supply. Last year, in the middle of the year, we said we thought an appropriate M–1 number would be at the lower end of that 3½ to 6 percent range that you referred to. We came in at 2.3 percent, a little more than 1 percent below that.

Senator **Bentsen**. But the quarter to quarter results are also important. I don't pay any attention to those weekly reports.

Mr. **Volcker**. Right.

Senator BENTSEN. Unfortunately the market does pay attention to the weekly figures. My question, though is why should the quarterly reports vary that much. Don't you have the mechanical means to do better than that? Or was that result intentional?

Mr. VOLCKER. We don't have the mechanical means for producing absolute stability in that number. The more interesting question is whether we should. I think what is important is that the trend be maintained in the right direction. And, of course, in judging even the trend, you have to judge the effect of various changes in the market.

Senator BENTSEN. But is it a consistent trend when the money supply contracts in the second and third quarter and then increases by 12 percent in the fourth quarter?

Mr. VOLCKER. Yes; but I don't think the second quarter contracted. I am not sure the third quarter contracted either.

Senator BENTSEN. I am told that the composite figures indicate that it did.

Mr. VOLCKER. If you take it from a peak figure in April, you can go several months and see a contraction. But the peak figure in April was higher than we wanted to see it. There was a bulge in April, and we were perfectly happy to see the money supply decline a bit from a bulge in April. You don't see that much difference in the quarterly numbers. There was some fluctuation in the quarterly numbers. M_1 was low over the summer following a peak level in April. Then it began growing again in the last quarter of the year.

These fluctuations were not out of line with historical experience. They are well within historical experiences in foreign countries. Then you face the question, which is a very real question, of how much more stability or rigidity you want to buy in monthly or quarterly money supply figures, at what expense. If you were going to use present techniques or adopt new techniques to enforce more stability on one particular aggregate, M_1, let's say, I think all the analysis suggests that you are going to have still more interest rate instability. Is that a good tradeoff? I don't think that necessarily is a terribly good tradeoff. In the end, it's the interest rates that are going to affect the economy.

I might also note that while we came in low on M_1 last year—even a bit below the lower end of the target that we said we were satisfied with—on M_2, another monetary aggregate that in some ways may be giving a more reliable reading, we came in about a half a percent high. We had to make a judgment, not just based upon one particular number that we know was affected by a number of changes going on in financial markets, but hopefully based on some kind of a balanced analysis of what was going on with all the aggregates and in the markets generally.

Senator BENTSEN. Are you saying that you do not need better mechanical tools to produce a more stable money supply—one that will have some continuity?

Mr. VOLCKER. We have proposed, in fact, some changes with respect to money market funds, but we have not made proposals beyond that. If it were the Congress' judgment that you wanted to, in the end, you can, in effect, control whatever we do. If you said the be all and end all was to have an absolutely stable M_1

number—I wouldn't recommend that—but if that was the law of the land, you would need additional instruments.

Senator **Bentsen**. Well, Mr. Volcker, the M_1 number is obviously not stable when it contracts for two straight quarters and then expands by 12 percent in the third. That kind of volatility causes the people in the bond market to build in a risk-factor discount. And that is not just a risk factor for inflation; it's one for movements in the money supply.

Mr. **Volcker**. I disagree with that, Mr. Bentsen. The question would never arise, we would not be in this colloquy, if the money supply came out nice and stable every month. I don't happen to think that is the nature of the beast. But the volatility that the market most worries about, in my judgment, is the volatility in interest rates. To the extent you have a tradeoff here——

Senator **Bentsen**. I think those two go together.

Mr. **Volcker**. I think they go together but in the opposite way that you are suggesting. If you enforce a rigidity on the money supply from month to month, you are going to have more volatility in interest rates, in my judgment. Apparently, there is a difference in judgment.

The **Chairman**. Senator Grassley.

Senator **Grassley**. Mr. Volcker, I support the independence of the Fed, and I suppose most of us in the Congress do. Independence appears to be leading to isolation. Last week in the paper it was reported that you had your third meeting with the President. Are three meetings with the President of the United States enough in 1 year? Is there going to be any change in the policies of the Fed as a result of that meeting last week?

Mr. **Volcker**. I think we have met more than three times. I am obviously perfectly happy and delighted and welcome as many meetings as possible. You asked whether as a result of that meeting there was a change in policy. I would have to point out, Senator, that I think in the broad intentions of policy, the administration and the Federal Reserves see things very much the same way.

Senator **Grassley**. Well, then have the reports of the President and Secretary Regan been wrong, the reports that have shown up in the media lately. Particularly, they have been challenging the volatility of money supply and the inability to control it. Have those reports been inaccurate?

Mr. **Volcker**. I read the reports in the media about the questions of volatility, but that is, in my judgment, a secondary issue. In terms of the basic thrust of policy toward maintaining restraint on the growth of money, I don't think there has been any disagreement at all.

Senator **Grassley**. Should there be frequent meetings between you, as a powerful economic leader in our country, and the President of the United States?

Mr. **Volcker**. In the end that's up to the President, of course, but I welcome as many meetings as he wants to have.

Senator **Grassley**. You don't see those meetings as useful tools for you doing a better job?

Mr. **Volcker**. Yes, I do.

Senator **Grassley**. You do. Well, then wouldn't more meetings enhance that without jeopardizing the independence of the Fed so that there is more correlation?

Mr. **Volcker**. I don't think there's any problem with the independence of the Fed in those meetings. I don't have that sense at all.

Senator **Grassley**. All right. Then on a second point, sir; you stated in an earlier answer to one of the questions that the markets still aren't convinced of the future of our economic policies. Do you think the criticism of the Fed in the marketplace for releasing monetary aggregates on Friday afternoons causing needless financial overreaction is warranted? Does the occasional overreaction by lenders jeopardize your achievement of long-term goals?

Mr. **Volcker**. I don't like this procedure of publishing the money supply weekly. Everybody all over the world hangs upon the publication of a weekly figure which, in itself, is not meaningful in any particular week. The question is what to do about it. I don't think our problems are going to be solved one way or another by whether we publish it or not. There is a presumption that if you have the information, you publish it.

Senator **Grassley**. Has there been any thought to announcing the aggregate less frequently?

Mr. **Volcker**. Yes, lots of thought.

Senator **Grassley**. And what's your feeling about that?

Mr. **Volcker**. My feeling has been, so far anyway, that the difficulties are less in doing it than not doing it. But that decision is constantly reviewed.

Senator **Grassley**. Are you satisfied with your tools for controlling and making your policy decisions, such as lagged reserve accounting?

Mr. **Volcker**. Right.

Senator **Grassley**. Are you going to change that policy to a more current method of accounting?

Mr. **Volcker**. That will come before the Board of Governors in a few weeks and we will make that decision.

Senator **Grassley**. Do you see any more support for it now within the Board as there was back in 1976 or 1977 when it was first suggested?

Mr. **Volcker**. I think the Board is of mixed opinion about it, and I wouldn't want to prejudge how they are going to come out.

Senator **Grassley**. Are the staff reports from your staff to the Board as favorable as they were in the decade of the 1970's when it was rejected?

Mr. **Volcker**. I don't remember the staff reports in the decade of the 1970's and I can't make that comparison. There are some technical reasons that point in that direction, and there is some staff view that it is a good idea. I think it would be wrong to suggest that many people in the Federal Reserve think it's a terribly crucial decision one way or the other.

Senator **Grassley**. You say there aren't too many people that think it is a crucial decision?

Mr. **Volcker**. I think that's correct.

Senator **Grassley**. OK. If that's the case, then there sure have been a lot of economists writing about it in the press and scholarly journals lately. Some experts say making the change is very important.

Mr. **Volcker**. There is one school of economists that thinks it is important to make that change. I don't happen to think it is.

Senator **Grassley**. Along that line, is there considerable opposition from the banking community toward the change because of increased costs to them?

Mr. **Volcker**. Yes. Generally, I think the banks are opposed.

Senator **Grassley**. How overriding is that opposition going to be?

Mr. **Volcker**. It's not overriding if you think it is important.

Senator **Grassley**. You don't think it's important?

Mr. **Volcker**. I don't think it's critical, no. But that doesn't say I don't think the bank objections are profound either. I don't think it is that much of a cost. In general, it's true that banks are not happy about the prospect. Many of them, as a matter of analysis, and many economists, as a matter of analysis, don't think it is very important.

Senator **Grassley**. I thought the recent literature on it was overwhelmingly in support of the policy change.

Mr. **Volcker**. I don't think that is true. There is a school of economists who think it is very important.

The **Chairman**. Under the "early bird" rule, I guess I am next. I apologize for being detained this morning. We had a meeting on the Caribbean Basin.

With reference to Senator Grassley's question about weekly reporting, would you feel more comfortable if there was some clear legislative authority to hold up the money supply data for say a month? Would that tend to smooth market performance?

Mr. **Volcker**. As things stand, we have two problems in not publishing weekly. There is a presumption, I think, in the law that we will publish under the Freedom of Information Act. There is a question as to what the status of this would be under the act, but I think there is a substantive presumption that if we collect the figures it is on balance useful to the market to have available the figures that are available to us.

I think there is a further question that I want to examine. Under our present techniques, we are bound to collect the data or something very close to them. We don't have to put them in precisely the form in which they are now published. I begin to wonder whether we want this data every week. That would involve a change in our operating procedures, because the reserves are now maintained on a weekly basis and that, in essence, is why we collect these figures weekly in the first place. If we didn't enforce reserve requirements on a weekly basis, but rather over a longer period, we presumably wouldn't collect them weekly.

A particular proposal that we made on contemporaneous reserve accounting, for instance, involved a longer reserve averaging period. If we adopted that proposal—while we certainly haven't made this decision—it would at least be consistent with that proposal not even to collect the figures weekly.

The **Chairman**. Are you worried at all about the 1982 deficit?

Mr. **Volcker**. You worry about deficits, but that's not the primary source of my concern.

The CHAIRMAN. In other words, if we wanted to pump a few billion dollars into the 1982 deficit.

Mr. VOLCKER. I'm not encouraging that. All I am saying is you have a much smaller structural deficit in 1982 than you have in each year moving out beyond that. If you could assume a good business year in 1982, if you didn't have the recession—the deficit would be of fairly modest proportions. The big difference between 1982 and 1984 or 1985, let's say, is that if you make that same assumption in 1984 or 1985, you have a very, very large deficit.

The CHAIRMAN. You wouldn't recommend that we just ignore the 1982?

Mr. VOLCKER. Not at all. Obviously, if you ignored the 1982 deficit and went about spending more in 1982, that would have repercussions in 1983 and the years beyond, too. You are just going to multiply your problems.

The CHAIRMAN. Well, there has been some discussion. I hope they find some bipartisan support. Maybe one way we can approach this is to act earlier in the year, rather than waiting to go through a budget process that may never develop in the first place. Maybe we could use the debt extension process that has been used in the past and put together an economic package of sorts, if you can find a majority of votes in the House and the Senate. Hopefully, that would send a clear signal or a signal that we were trying to come to grips with the deficit. I think, very honestly, that many in the Congress who are concerned about the deficit aren't going to cut spending. They are going to make speeches and wring their hands, but when it comes to voting, let's say, to reduce medicare—maybe I had better not use this sample because I know we are all going to do the right thing. Let's just say in some other committee when it comes to voting to reduce a program, you may find some slipping off. So I think what you are suggesting is the best way to reduce the deficit is to look at the spending side.

Mr. VOLCKER. Yes.

The CHAIRMAN. And if that fails, then the revenue side.

Mr. VOLCKER. Yes.

The CHAIRMAN. But if you were going to list the way we should, it would be in that order. And without being specific.

Mr. VOLCKER. Yes.

The CHAIRMAN. I think you have indicated you are not prepared to say we ought to dismantle last year's tax cut. We are looking at specific provisions like the leasing provisions. I don't imagine you want to comment on that. But we do have a responsibility where we believe areas may be too generous or whatever to take a look at them. There are all kinds of ideas on just what we should do. Senator Domenici made a speech in New York last evening; laid out another plan.

Now you have testified before the Joint Economic Committee, the Senate Banking Committee, the House Banking Committee and the House Ways and Means Committee. During those pleasant moments before all those committees, did we, in essence, cover everything that you think might be helpful to go to work on this $100 billion problem that you described that we have to the, I think, Senate Budget Committee?

Mr. VOLCKER. I think all the points have come out. I continue to feel there is a certain amount of confusion, so let me just emphasize it again. My concern is what those deficits look like in a "no-action" scenario, because I think all the analysis before you points toward a rising structural deficit. I think that is the heart of the problem. All those figures indicate that you really have a very big job in front of you in 1983, 1984, and 1985. You can argue about whether the magnitude of the 1984 job is $85 billion or $110 billion or $100 billion, but that argument pales in significance compared to the necessity of getting to that area in the first place. Obviously, I have a certain concern, given the magnitude of the job, that we will end up with something, let's say, much less than what the President has proposed; he has already taken a very large swipe at the problem.

The CHAIRMAN. But to get to his $91 billion, you have first got to find $50-60 billion.

Mr. VOLCKER. That's right. You have first got to find the $56 or $54 in 1983. And you have got to find $84 billion in 1984 to get to his figure in that year. That's what I would emphasize; the magnitude of that job.

The CHAIRMAN. We have a vote in progress. We will hurry back. I know you have some time constraints. The Fed doesn't rate the Congress so we don't get any ratings. We rate the Fed a lot. Do you have a system down there that rates the Congress?

Mr. VOLCKER. No.

The CHAIRMAN. You haven't asked anybody to resign in Congress.

Mr. VOLCKER. No. We try to work together.

The CHAIRMAN. I think you are doing a good job. I just want to suggest—I assume there is a temptation for some, particularly in my party since you are not a Republican appointee—because at scapegoating time we can't find any easy answers so we start looking for a target. So as big as you are physically and also because of the importance of your role, I assume you are fair game. But I want to suggest that that view is narrowly held. And we believe that your meetings, as Senator Grassley said, with the President, with Don Regan, indicate that there is a broader problem here. It's not a Fed problem. It's not a congressional problem or it's not an executive problem. And it's a little early for scapegoating, it seems to me.

Mr. VOLCKER. There is no question that we all have a very large problem before us. We are in the midst of a very difficult period. But I just want to record that I think we are also in the midst of a transition toward a much more satisfactory future than what we had in the 1970's when we had a progressive deterioration in the economic situation. I think we are laying the foundation for a progressive improvement in the economic situation during this decade.

The CHAIRMAN. Are you fairly optimistic on interest rates this year without saying what they are going to be?

Mr. VOLCKER. I am optimistic in the sense that I think they are extraordinarily high for any prospect that I see for inflation, looking at the business situation and all the rest. I would assume that with correct actions on our part and on your part, interest rates have no place to go but down. We want to facilitate that process and do it in a way that is not just a flurry. There is no point in adopting a policy that may, for 2 months, make everybody feel good, because if things go down, they might pop right up again. We have to do something more fundamental than that.

The CHAIRMAN. Mr. Volcker, if it is all right with you, we will have a recess for a couple of minutes. Senator Boren and Senator Baucus would still like to pose some questions. They will be back when they vote. We will stay in recess until some Senator returns.

[Whereupon, at 10:55 a.m., the hearing was recessed.]

AFTER RECESS

Senator BYRD. The committee will come to order. Mr. Chairman, I haven't been able to be here for the entire meeting. A group from the Virginia Legislature is in the Capitol along with the Governor on a matter affecting Virginia.

I rather suspect that some criticism this morning was made of the Federal Reserve Board. I don't know, but I have heard on the floor of the Senate the Federal Reserve Board condemned for high interest rates. I just want to say that I do not associate myself with those comments. I think that it has been that the high interest rates result to a very considerable degree from the continued reckless, irresponsible spending by the Congress of the United States over a period of 15 to 20 years.

I think the Federal Reserve Board is doing what needs to be done. I think the Congress of the United States has not done what needs to be done.

I don't find among my colleagues a willingness to get spending under control.

The press reports that there has been great reductions in spending. There have not been reductions in spending. There have been reductions in the rate of increase in spending, but there have not been reductions in spending.

I know the Chairman of the Federal Reserve Board in his statement today and in other public statements has expressed great concern as to the magnitude of the projected deficits. The Senator from Virginia wants to express the same view.

Frankly, I am alarmed at the prospect of 3 consecutive years of $100 billion deficits. I am convinced that this year will end with a deficit of more than $100 billion. Next year, the deficit will exceed $100 billion. And possibly the third year, likewise. I think that's highly dangerous. The Congress must get into this act of controlling inflation. And as a result of that, controlling or bringing down interest rates.

Now, Mr. Volcker, on page 4 of your statement, you say, "Credibility in dealing with inflation will have to be earned by performance and persistence over time." It seems to me that that is absolutely sound. We can't correct what has been going on for so long in a short period of time. We must have a consistent and persistent policy.

On page 8 of your statement, you say, "All the estimates before you, by the administration, by the Congressional Budget Office or by private forecasters, point in the same direction." Namely, high deficits. "In the absence of action to close the potential gap, the deficit will rise to about $150 billion or more in 1983, and to still larger amounts in later years." That's even a little more pessimistic than the figures that I have been working with.

Mr. **Volcker**. Those are the figures, if I may just interject, Senator, that the administration and the Congressional Budget Office lay before you in the absence of action.

Senator **Byrd**. Well, I think it is even more alarming than I had asserted a moment ago. I note you say "in the absence of action."

Mr. **Volcker**. That's an important phrase. I literally mean, "in the absence of Congress doing anything."

Senator **Byrd**. And I don't look for Congress to do too much. I don't look for Congress, for example, to support reductions in the rate of increase in spending that the President has proposed. And I don't look for Congress, and maybe justifiably so, to increase some of the taxes that the administration has proposed. So I think that these may be more realistic figures than the ones that I have been working with.

Now in page 9, you say:

> The deep-seated public instinct that sustained large deficits will lead, sooner or later, to pressure to create more money to finance those deficits, or will otherwise stimulate inflation, which undercuts the effort to restore stability.

There again, it seems to me that that is a sound, logical, commonsense approach to our problem. I think the public does feel that these continued accelerated, accumulated deficits are bound to lead to more inflation; it's bound to lead to continued high interest rates.

Now in page 10, you assert:

> Given the nature of the problem before us, and the clear risks of underestimating the size of the budgetary problem, I can only conclude that the Congress should set its sights for still larger budgetary savings, keeping in mind the widening gap now projected beyond fiscal 1983.

There again, I think you are totally correct. But I don't see the Congress, either the Democratic House or the Republican Senate, setting its sights—it may set its sights but I don't see it accomplishing or being willing to accomplish a larger budgetary saving. In my judgment, there should be a larger budgetary saving; there should be less spending than has been proposed. But I think the likelihood is it will end up with more spending.

So, Mr. Volcker, I just want to say that I think the points you make in your statement to the committee today are sound in my judgment and I would hope that the Congress would take to heart your deep expressed concern for the need to show more budgetary restraint, to reduce spending to a greater degree than has been proposed, and to reduce the horrendous deficits with which this country is now faced.

The **Chairman**. Senator Baucus.

Senator **Baucus**. Mr. Chairman, in response to the points put to you by Senator Bradley, you mentioned that probably as important as it is to get spending down for fiscal 1983 and the deficit of 1983, it is probably more important to address the out-years, 1984, 1985, to set the pattern.

Mr. **Volcker**. They go together.

Senator **Baucus**. Yes. They go together. That is really my question. I am curious as to how we set that pattern without significantly cutting the 1983 deficit. I am looking at the out-year defense spending or other out-year spending programs and even the taxes we put in place or don't put in place in fiscal 1983 as they affect future years. It seems to me that to set the pattern you mentioned, you have to act.

Mr. **Volcker**. No question of that. You have to act in 1983. You have to act now to affect 1983 and if you are going to get the momentum going in 1984 and 1985. You have to act significantly in 1983. Again, the President has already proposed a $55 billion program, and we were just talking about how urgent it is to go beyond that. I was expressing even more urgency for the years beyond 1983.

Senator **Baucus**. I perhaps misunderstood then. I was a little surprised that you didn't seem to——

Mr. **Volcker**. No, there's constant confusion, I'm afraid, about looking at this before or after the President's proposals. My remarks are couched in terms of the raw budget before the President's proposal. In my colloquy with Senator Bradley, I was assuming that you would go at least as far as the President went in 1983.

Senator **Baucus**. But I'm wondering whether it is important to go even farther than the President proposed for 1983.

Mr. **Volcker**. In my judgment—and we are in the area of reasonable debate I suppose—it becomes more important beyond 1983. We need to get in motion programs that will make even further progress in 1984 and 1985, when I would hope and expect—it partly rests on the fiscal action—that the economy is going to be operating at a higher level. We are going to want to see more home building, more private investment, more of other sectors that compete with the Government for the supply of savings.

Senator **Baucus**. Moving to another area. The central question is that the interest rates are so high, but with inflation coming down, at what point, in your view, does the cure become worse than the disease? That is, at what point is the discrepancy between interest rates and inflation so great that perhaps there is time for the Federal Reserve to adopt a different course? I don't know what that would be, but I would be curious where in your mind that would become so large.

Mr. **Volcker**. I don't think we are going to be faced with that. The question presumes that there is some alternative course that will assuredly bring interest rates down—not only bring them down for a few months, as we were just discussing with Senator Dole, but keep them down. It will profit us nothing to embark on a heroic effort to bring interest rates down for 3 months to find out that we have undertaken a policy course that in the next 6 months sends them up.

Senator **Baucus**. I'm not asking you whether you think interest rates are going to come down or not or whether inflation is going to come down or not, but at what point in your view would the discrepancy be too great? That is, what if inflation on an annual basis were to stay at a very low rate, 6 percent, 7 percent. With the way interest rates are now, would that cause you to change your course in anyway?

Mr. **Volcker**. I don't think the interest rate level in itself can be singled out in terms of that judgment. I think what you really have to ask is what is going on in the economy generally.

Senator **Baucus**. I'm assuming that unemployment remains high and interest rates are high.

Mr. **Volcker**. It is always possible that, taking a look at the economy as a whole, taking a look at changes in financial markets, behavior of individuals, behavior of businesses in holding money, you will reach a conclusion that you have got the wrong monetary target, and you would change that. I don't anticipate that happening, but you are, I suppose, hypothesizing situations where we would want to do that. I cannot deny that that situation hypothetically can arise, but I can't judge right now all the circumstances that would lead one to that conclusion.

Senator **Baucus**. I mention it because when I was home during this last week, this is a point that came out very often in talking to businessmen. That is, they felt that inflation has come down so much that it is time for the Federal Reserve to ease up a little bit. That's how they analyze it. And that's why I'm asking the question in the way that I am.

Mr. **Volcker**. I think there's always legitimate argument as to precisely where those targets should be, precisely where we should be within those targets. We've expressed our judgment on that very recently in setting these targets, suggesting we'll evaluate all the factors that you've mentioned and others. Right now we think it is acceptable if, on the M_1 number, we come out on the higher part of the range, or that we come in on the high part of the range on M_2. We've taken those kind of factors into account.

Senator **Baucus**. Let me rephrase it slightly differently. That is, a lot of the talk, you say, is on inflation rate, M_1, and unemployment, growth. Those are averages. Is there a point at which you or the Federal Reserve will begin to change course in some way? At what point is the discrepancy so great that you begin to become alarmed? And if we look at credit allocations or if we look at something.

Mr. **Volcker**. I can't give you any particular signal. I can say I think there is implicitly a process of continuing review.

Senator **Baucus**. Is there a point? If you analyze the economy to the extreme between big business or large businesses—the extremes in the economy become so great that aren't seen in the averages that you do something?

Mr. **Volcker**. We are hypothesizing, I suppose. Conceptually we could reach the conclusion that there is something going on that we didn't anticipate; some change in relationships that we didn't anticipate that would lead us to conclude that, let's say, we had to increase the supply of money further than what we say now, or the reverse. Last year, for instance, we got half way through the year and we observed what was going on, made the best judgment we could, partly on technical grounds, that the money market funds were providing some substitute for M_1-type balances, and that we would be satisfied coming in low in that range. We undershot M_1 slightly at the end of the year. You could arrive at the reverse judgment at some point. We did arrive at a judgment; at the moment, we find it acceptable to be in the upper part of the range and to permit the money supply to run somewhat above those cones that people like to draw with our ranges for a while, in the light of all that had gone on and was going on currently.

I think your question suggests maybe a more discrete point than typically exists, because we are constantly making these judgments as we go along. We will certainly stick to the general points; that the prospects for the economy are not going to be improved—in fact, the prospects for a sustainable recovery will be damaged—unless we are concerned with the inflationary problem and the possibility that an excessive growth in the money supply can reignite the inflationary process. We are just beginning to see the kind of progress that we need on that front. Within that general framework, a precise number, precise action naturally can be reviewed. We have a lot of experience behind our judgment as to the general course of the money supply and its relationship to inflation.

Senator **Baucus**. My time is up. Thank you very much.

The **Chairman**. Senator Boren.

Senator **Boren**. Mr. Chairman, the interest rate situation—I think there are many of us who feel there not only cannot be an economic recovery until interest rates begin to come down so that we can have the growth in the private sector we need, but also that if they do not begin to come down relatively soon, very soon, that we are going to have a very sharp break in the economy. My question to you is how long do you think the economy can sustain either the present rates of interest or what appears to be some long range possibility that the rates will go up. As people look down the line at these out-year deficits that you are talking about, I think the market is responding rationally. I don't think it's an irrational response at all when they see the kind of out-year deficits that are looming. We've indexed our revenue to go down and indexed our payout to go up. I think anybody looking at that would say what is going to happen to Government borrowing in the future. When it is increased, there is going to be more crowding out. We don't want to be caught like the thrifts and others so we are going to put even more of a pad in our interest rates.

Mr. **Volcker**. I think you have described part of the process that is going on very eloquently.

Senator **Boren**. So if we don't make any changes here to avert that and to change the outlook by stopping the indexing reducing the deficits, reducing the Government borrowing pattern, we could have interest rates going up. How long do you think the economy could sustain interest rates at or above the level that we now have without some kind of serious problems?

Mr. **Volcker**. I don't think I can make that judgment with any degree of precision. Obviously, we would be happier to see interest rates going in the other direction. It would be healthy for the economy. It would be healthy in supporting a recovery. How long will rates stay at what precise level, I don't know when; that is a very difficult judgment to make.

There are a lot of factors out there. Let me say that the principal problem at the moment seems to me to be this one in financial markets. There are other factors in the economy that would, on any kind of typical analysis, suggest that the economy is getting to the point where a recovery would be a normal expectation. Indeed, that is our feeling of what is most probable.

You've got production rather sharply cut, inventories declining, consumption supported in part by the large deficit that is going on and prospectively by the tax reduction at midyear. There is a lot of good, old-fashioned business cycle analysis that suggests we are approaching a phase of recovery. Now the financial market looms there as a stone in that path.

Senator **Boren**. But wouldn't you say again though that the failure of interest rates, again caused by their expectations, to come down is really a major impediment here?

Mr. **Volcker**. Yes.

Senator **Boren**. Because it is also drawing into interest payments funds that would otherwise be available for increased consumption to help the economy.

Mr. **Volcker**. Yes. Of course, those interest payments end up in somebody's hand, too, and are available for consumption in some sense. But they certainly add to the pressures on business. We have business profits severely squeezed at the moment, and that's an adverse factor in the situation. But I agree with the thrust of what you are saying.

Senator **Boren**. Well, because of the cause of the problems that we have just discussed, there are many people—I happen to be one of them—who are very, very concerned that we could have a sharp break in the economy in the next 12 months if something doesn't happen. And when I was talking to people at home—I was particularly talking to people in agriculture and small business—many of them see this as a very personal thing to them. Many of them that have talked to me, laid out graphic detail, confidential details of their personal problems. And these were very solid people, not marginal people in agriculture and small business. And they are barely hanging on. They can't really make it. Some of them can't make it as long as a year. And what they say to me is:

> It looks to me like no one is really pulling it all together. What we ought to have right now is a coordinated emergency economic program. It ought to include the administration; it ought to include the Congress; and it ought to include the Fed. Why aren't they getting together?

One of the reasons I called on the President to withdraw his budget and start over, to sit down with you, to sit down with Chairman Dole, and to sit down with people like Senator Baker, Senator Hollings, Senator Domenici, and others, and let's work out an emergency program we can all agree on. And I think the country would accept it.

If you were drawing up such a program and you had the freedom and you were in such a meeting with key congressional leaders and the President and with yourself being present, and you were called on as to what you see the central thing we might do together? I gather part of it would be to say go to work on the outyear deficit.

Mr. **Volcker**. No question.

Senator **Boren**. A very principal thing. Get them lower even than the President has talked about.

Mr. **Volcker**. Precisely.

Senator **Boren**. Are there other elements that might be forthcoming? For example, the transfer of funds to money market, no reserve requirements in terms of any kind of a level playing field that applies to money markets, that applies to bank deposits, some possible discussion of temporary dual credit policies or other kinds of policies that might assist in the short run while we are working on the real cure. What other kinds of things would you like to mention in that if it were to be held?

Mr. **Volcker**. Let me object, if I can, to the premise of your question. I don't think the economy is going to have the kind of rate that you suggest.

Senator **Boren**. I hope you are right.

Mr. **Volcker**. Obviously, we all hope that that is right. But I also do not think economic policy is in quite the degree of disarray that the question may presume. I think a lot of pieces have been put in place that should be a central part of a sustained policy. You have done some things in the tax area. You are left with a budgetary problem.

Senator **Boren**. Yes.

Mr. **Volcker**. Just looking at incentives, savings, and all the rest, I think they move in the right direction. I think monetary policy, broadly, is in the right direction, too. I think we see progress on inflation; that is fundamentally important. On the regulatory side, I think we are seeing progress. We've maintained open markets internationally. We see more competitive pressures where perhaps they are needed domestically. A lot of fundamental things are going in the right direction. We are not talking about moving off in a grand new program as your question may have implied, but there are things that need to be done. We want to reduce any risks that exist of the kind that you see. And, of course, the thing that is missing is that budgetary outlook at the moment, and that seems to me to be the most important thing.

You referred to things like money market funds or credit allocations. We've made some proposals with respect to money market funds, but I don't think they are central to this effort; I wouldn't want to put it out of proportion. We think both from a standpoint of managing monetary policy and for equity reasons the proposals we made are very sensible. But I wouldn't elevate them to the importance of the budgetary problem, the tax policy, general monetary policy.

Senator **Boren**. At the margin.

Mr. **Volcker**. At the margin, those things are useful. But I just don't think they are central to the success or lack of success. When you get into a whole different approach of credit allocation, our experience on that has not been very happy, historically. We did that in somewhat different circumstances, although the circumstances also had some similarities, in early 1980. We got a degree of reaction that hadn't been bargained for, you may recall. I don't come away from that experience with feeling that that is a promising approach for handling our economic problems.

Senator **Boren**. The reserve requirements for the money market. Something along that line. But that requires legislation.

Mr. **Volcker**. That requires legislation. And it is partly a matter of equity in that case.

Senator **Boren**. Right.

Mr. **Volcker**. Our proposal was a rather modest one. Just to remind you of it, to the extent the funds are running a checking account business, they ought to segregate that business and play under the same rules as banks.

Senator **Boren**. Right.

Mr. **Volcker**. To the extent they are not running a checking account business, they wouldn't.

Senator **Boren**. If I could just ask one followup here. On the size of the deficit—again, I realize this is like asking you, you cannot say how many months or years—but in terms of ball park figures, in terms of reducing the outyear deficit—of course, we have estimates that are very hard to private economic analysis concensus that could add something like a trillion to the debt over the next 5 to 6 years under the budget. The CBO says something in the neighborhood of $400 billion that would be added to the deficit if we used the President's administrative assumptions over the next 6 years. Now what would you say in ball park figures if we were to adopt in toto the cuts suggested by the President? We were talking about building in enough of an additional cushion that we think would effect the psychology of the market enough that it would help to bring down the interest rates. Are we talking in terms of say on the 1983–84 looking down the road, or are we talking about another $40 to $50 billion of reduction of the deficit a year? Is that a ball park area?

Mr. **Volcker**. You are quite right in saying you have got to talk in a ball park area when you get out in that area.

Senator **Boren**. Right.

Mr. **Volcker**. I guess the way I would put it is that if you did everything the President was asking for, something with that net result, you would get in the ball park, but not as comfortably as I would like to see it. You are getting in a range where it becomes a matter of judgment as to how safe you want to be. Given precisely the concerns that you expressed at the start, I would urge you to go beyond that, because I think it provides a safety margin and more assurance. If you do everything the President asks for with reasonable projections of savings and all the rest, I think you then begin to get within the range of historical experience, although you are kind of on the high side in terms of historical experience. I would like to see you go beyond. I have used the figure on a number of occasions of $100 billion compared to his $80 to $85 billion in 1984. It would be better if you went beyond that.

Senator **Boren**. So, if we went somewhere $20 to $40 billion less deficit—I realize we don't know whether we are arguing apples or oranges.

Mr. **Volcker**. Right.

Senator **Boren**. Let's say the $91 billion figure is right for next year. And the figure for the following year is right.

Mr. **Volcker**. Right.

Senator **Boren**. Instead of $91 billion, if we were using all his assumptions—keeps apples and apples—if we were to go to $71 instead of $91 or down as far as say $51 or $61, if we got down that far, you would feel very comfortable—again realizing we have to look at indexing and some other things that will directly affect outyears.

Mr. **Volcker**. Right.

Senator **Boren**. But you would feel comfortable in predicting at that point that psychologically the markets would begin to react by feeling less of a need to have a cushion?

Mr. **Volcker**. If the market felt some assurance of that kind of outlook, I feel quite confident that it would react and react strongly. You face a market now that might react favorably if you enacted an amount equivalent to the President's program. My judgment is that they don't believe even that is going to be done.

Senator **Boren**. Thank you, sir.

Senator **Mitchell**. Mr. Chairman, I would like to ask you one more question. You have rightly stressed here today and over the past many months the need to control inflation. Some economists have suggested that one of the deficiences in our current approach is that we have no mechanism for directly dealing with the wage, price spiral, and the effect that that has on inflation.

Mr. **Volcker**. Right.

Senator **Mitchell**. So, there has been suggested, I guess what is most commonly described as a "tax based incomes policy" that seeks to use mechanisms of the Tax Code for incentives to encourage anti-inflationary behavior by both labor and management. Would you comment on that? What is your general reaction to that?

Mr. **Volcker**. The problem toward which that kind of policy is aimed is very clear, and the logic is very clear and very attractive from the standpoint of trying to resolve these problems. I think the problem is a practical one. Can that kind of approach be made workable, sustainable, equitable? I think on that score, however attracted one is to those proposals in concept, they begin to break down. What do you actually do? Is it sustainable? Can you administer it? Is it going to be fair? Is the public going to tolerate it?

Tax-based incomes policies are a response to the evident problems that we have had with earlier attempts in the same general area—with more overt controls or more voluntary programs. The experience, overall, has not been so successful, to put it mildly, that you have any justification for putting a lot of weight on that right now.

If we could develop institutional arrangements, some sense of greater coherence, greater concensus, in this process, as time passes, I think we will be better off, but I don't think we can do it right now. We haven't got the groundwork. We haven't got the administrative capacity to do so. There is some possibility; I don't want to put too much weight on it, but other countries have done this a little better than we have through the years. Maybe we have something to learn in this area.

I have to make one final comment. I don't think that kind of thing can in anyway be a substitute for monetary discipline or fiscal discipline. One of the great dangers of that kind of program is, like it or not, people do look at it as a substitute. They say, "OK, if we are doing this, you go ahead and expand the money supply or you go ahead and run big deficits." I think we can be sure of one thing; it's not an either/or proposition. If we go ahead and have an inflationary increase in the money supply, it is going to be inflationary in the end regardless of these other programs; they are not a substitute.

Senator MITCHELL. I didn't suggest it as such. I gather what you are saying is that you have no problems with the concept of the process but you are skeptical about whether or not it can be practically implemented.

Mr. VOLCKER. That's right. I don't know when the practical reservations seep over into a philosophical reservation. I certainly recognize why people talk about this, why they think about it. They think it is an area that has affected all advanced, mixed economies; that is, how you reconcile in the end high levels of employment, very low levels of unemployment, with maintaining an equilibrium in the labor market that doesn't give you an inflationary problem. An inflationary problem, in the end, will undercut the prosperity. If we can devise, in time, a different kind of institutional arrangement in that market, obviously, it can be helpful. I don't want to express the feeling that I think it is relevant now or that there is some kind of a magic answer out there in the future.

Senator MITCHELL. No. But to the extent that the large wage settlements continue to exceed productivity by large margins, you would agree that the problem of controlling inflation is simply made much more difficult.

Mr. VOLCKER. No question.

Senator MITCHELL. Thank you.

Senator BRADLEY. Mr. Chairman, last time we talked about eliminating the tax cut in July of 1982. What if the tax cut were accelerated from July to say January and no tax cut were provided for 1983 or 1984? This is the idea that Senator Domenici floated last night in New York. Is that the kind of relief you would recommend?

Mr. VOLCKER. I haven't seen Senator Domenici's speech.

Senator BRADLEY. I think that's what Senator Dole was alluding to earlier.

Mr. VOLCKFR. Right.

Senator BRADLEY. When he asked whether it would be helpful if we could push some of this deficit off into 1982.

Mr. VOLCKER. I haven't got any direct responsibilities in these areas and cannot reply in detail on whether this particular tax measure or spending measure is better than another one.

Senator BRADLEY. OK. Let's go to another question. Inflation is much lower than it has been in recent years. Interest rates are very high. The real interest rate is very high. You have said that you want to keep the interest rate high to try to squeeze as much inflation as you can out of the economy. And you then said earlier that you felt that these high rates of real interest would refute the claim that as the economy starts to heat up again, as we begin to grow, interest rates will then go up. Could you play that scenario once more?

Mr. VOLCKER. I wouldn't describe it as the possibility of heating up again. Heating up has some vision of boom and so forth. All I am saying is that given the starting point of interest rates that are historically very high, I see no reason why you cannot have a recovery proceed at a reasonable rate of speed for a very considerable period of time without bringing more pressure on credit markets and on interest rates. Indeed, I can see the possibility that they would and should decline because these interest rates are abnormally high if we are going to continue to make progress on inflation. One great hazard that the market, in particular, focuses on now is that the chances of that happening are gravely diminished if you are going to run these big deficits during this period. We want to do everything we can to enhance the possibility of that happening.

One element of that, I think, is maintaining a disciplined monetary policy, but another element is maintaining disciplined fiscal policy, and that is going to require some action. If you put those prerequisites in place, I just don't see any reason—I don't accept the notion—that economic recovery has to bring higher interest rates.

Let me point out that as recently as during the recovery from the 1974–75 recession, I think it is roughly true that 18 months after that recovery started, interest rates, particularly at the short end, were lower than when the recovery started.

Senator BRADLEY. But if deficits continue, they will eat up a big chunk of private savings.

Mr. VOLCKER. Exactly.

Senator BRADLEY. And, therefore, the critical point here is the level of deficits. Now, as you look out at 1983, 1984, 1985, at the projected deficits, assuming the cuts the President has asked for in 1983, and as they carry through to 1984, do you see at those levels of deficits the likelihood that we will be able to finance them and still not provide the remainder of the private market with a situation where there will be very serious competitions for credit and therefore push up the rate? Or must we go more?

Mr. VOLCKER. More; and I think you are in the ball park. I would feel more comfortable if you went beyond that, but you begin to get in the ball park in that area. Obviously, I feel much more comfortable with that than with the present situation.

Senator BRADLEY. You and I and every Member of the Congress know that there are two ways that you spend money. One way is through the budget process; the other way is through the Finance Committee. And the assumption of these big tax cuts last year was that they would drive up cuts in the budget. Another possibility that is occuring to more and more of us is that they might foster more significant closing of various loopholes. Now, from your perspective, is that neutral from an economic standpoint?

Chairman VOLCKER. It depends upon the loophole, I suppose, but I would certainly think that is an area you can look at. That is one of the options before you, a very clear option.

Senator BRADLEY. Roughly, the tax expenditures are $260 billion.

Chairman VOLCKER. Right.

Senator BRADLEY. You know you are facing deficits. We've cut spending $130 already.

Chairman VOLCKER. The President has proposed you look at some of these.

Senator BRADLEY. Well, he has proposed we look at the equivalent of $7 billion.

Chairman VOLCKER. Right.

Senator **Bradley**. Now $7 billion out of $260. Meanwhile, we are going to cut spending $26 billion. From your standpoint, it is neutral, right?

Chairman **Volcker**. Right. You would have to look at the particular tax expenditure, but those are fair game. I don't see why you shouldn't look at them. Let me express the point more broadly and perhaps, therefore, less helpfully. There are lots of areas you can look. You have got the deficit problem. Ideally, you would close that deficit by taking measures either on the spending side, or on the tax side, where the action you are taking has other benefits as well. One area that comes up repeatedly is what you do in the energy area.

Senator **Bradley**. If I could just interrupt. The energy area, let's say if tax credits don't mean much, and we are going to get big dollars out of the energy area, looking at intangible drilling costs——

Mr. **Volcker**. I am thinking, in that case, of putting on a tax.

Senator **Bradley**. OK. What about things like employer contributions to health plans or taxing unemployment compensation or eliminating deductions for consumer interest or a variety of other things that are all provided for us?

Mr. **Volcker**. I literally don't know enough about some of those things. You mentioned health care deductions. I know that we have a big problem. I don't know the answer to it, but one of the sectors of the economy where costs and prices are rising the most rapidly is the medical area. That's also an area where you have got a lot of third-party payments.

Senator **Bradley**. Could I ask you then, out of the $260 billion of tax expenditures, which ones would you advise us not to touch for the health of the economy?

Mr. **Volcker**. Looking at it strictly from an economic standpoint, I suppose you should be most cautious about those that have a clear and direct rationale. I am speaking as an economist now. Those that affect investment, savings incentives, and so forth may be really useful. One that was enacted last year was the all savers certificate. I was not very enamored with that at the time. I don't think it is a very useful tax expenditure in terms of accomplishing the stated objective. Of course, that is scheduled to expire next year.

Senator **Bradley**. But that's one that we can cut.

Mr. **Volcker**. That's right.

Senator **Bradley**. So your general advice would be don't touch those that have the broadest general incentive for savings or investment?

Mr. **Volcker**. Right, if they are effective. Some things go under that label and are not very effective, but if it is one that is not effective, look at it.

Mr. **Bradley**. Which brings us back to one man's loophole is another man's incentive.

Mr. **Volcker**. That's right. And, fortunately, for all my other sins, I don't have the job of having to make that particular decision.

Senator **Bradley**. Why don't we emphasize M_2 more than M_1? That's my last question. Why don't we report it?

Mr. **Volcker**. We report it monthly for a statistical reason; that's when we get the number. We don't have that number weekly. I think your question is appropriate. Looking at the Open Market Committee, you have got 12 people, and you will get a different answer to that question from each of the 12. But I think it is fair to say that there is a feeling that that figure in some ways may give you a more reliable reading than M_1 particularly, in the short run. Historically, it has moved rather erratically because of all these interest rate ceilings.

Senator **Bradley**. In a deregulated environment, isn't it a more accurate reading?

Mr. **Volcker**. Yes, there is some evidence of that. Since the important deregulation that was made in 1978, I guess, M_2 velocity in technical terms has been much steadier than M_1 velocity on an annual basis, which suggests that it has some meaning. Indeed, we give it weight; there is no question about it. We do give it weight in our policy determination.

If you ask a group of economists who may agree upon the importance of monetary targeting and monetary restraints and all the rest, you are likely to get as many different proposals as to what is the right aggregate to look at as there are economists—we haven't got as many aggregates as there are economists. If you have three economists, you may get three different proposals. We take all of them, and if we think one of them is distorted for one reason or another, obviously, we discount it at that particular time. But you can't arrive at a fair judgment without looking at a variety of evidence, certainly including M_2.

The **Chairman**. Senator Byrd had a final question. We do have four economists next. And we hope to get four views.

Mr. **Volcker**. Maybe you will get four answers to that question.

Senator **Byrd**. Just one brief question. Some economists recently have stated that they feel that the inflation rate is underestimated. I wanted to know what you consider to be the true inflation rate.

Mr. **Volcker**. The inflation rate?

Senator **Byrd**. Inflation.

Mr. **Volcker**. I can quote some figures to you. The producer price index has been a little more than 4 percent in the past 6 months. The Consumer Price Index is around 8 percent. If I remember the figures correctly, it was 8.9 percent for the whole of 1981. If you look at some broader based industries, if you look at the trend in wage costs and make some allowance for productivity, you will probably get a figure in the area of 9 percent now. It is beginning to move down some but not as dramatically as the producer price index indicates. Those figures may be a better reflection of the inflation that is embedded in the economy at the moment. You are in there somewhere under 10 percent, I would judge—I hope coming down and I expect coming down. The particular indices that are so widely used—the producer price index and the Consumer Price Index—do show a better record. That will help, I think, to effect wage claims and other factors in the economy so as to help bring down the inflation rate over a persistent period of time.

Senator **Byrd**. Would it be reasonable to say that the currect inflation rate is somewhere between 9 and 10 percent?

Mr. Volcker. I would put it closer to 9, I think, moving lower on a trend basis. It depends upon what you mean by the inflation rate. If you look at direct prices that people are paying, it's lower than that. If you look at what looks to be the underlying rate, I think it is in that neighborhood. The current inflation rate, as measured in actual prices, is less than that.

Senator Byrd. The Federal Reserve Board is the No. 1 inflation fighter. What does the Federal Reserve Board consider to be the inflation rate?

Mr. Volcker. I guess we are talking about definitions. Using a commonsense definition, I think the inflation rate currently is probably 8 percent or lower.

The Chairman. Senator Symms.

Senator Symms. Mr. Chairman, I apologize that I wasn't here. We had highway hearings this morning which I had to chair. But in view of that, if I have any questions, I will just submit them in writing to the chairman.

The Chairman. I might also suggest that Senator Wallop would like to submit some questions in writing. We will have those.

[The prepared questions follow:]

Answers by Hon. Paul Volcker to Questions From Senator Wallop

1. Mr. Volcker, a recent Congressional Budget Office study entitled "The Prospects of Economic Recovery" states that the Economic Recovery Tax Act is expected to boost economic growth by stimulating consumer demand and raising incentives to save. And noting that it may take a little longer for the savings and investing effects to develop, they are vitally important to economic growth and productivity. In almost the same breath, the report goes on to note that monetary policy is expected to be exactly opposite to that of fiscal policy—that high interest rates will restrain consumer spending and that "there is considerable risk that tight credit conditions will offset the investment incentives of the act." This study further notes that the fiscal policy is not expected to have much of an effect on inflation, but that wages are the critical factor in that area. With that in mind, could you explain to me, what interest is being served, by monetary policy which restricts, at the very least, the Economic Recovery program the Congress put in place last year?

2. Mr. Volcker, I have a chart in front of me that shows the percentage increases and decreases in M_{1B} since 1978. Of particular interest to me is the incredible change in the consistency in the fluctuations of M_{1B} beginning right around the first part of 1980. It seemed that on several occasions last year, and this year, I heard reports that the basic supply of money unexpectedly dropped or increased more than projected, and no one had an explanation. How can there be a consistent monetary policy when there does not appear to be any mechanism by which M_{1B} can be controlled, or anyone who can explain it in any event? Is it proper that something which you cannot control, should have such control over the direction interest rates take?

3. Mr. Volcker, I realize that there have been modifications to the formula used to compute M_{1B}, but does that explain the extreme deviations from what was a rather consistent pattern before 1980? Are those deviations at least in part attributable to policies which you have followed—policies which may in large part explain the large risk premium in interest rates now?

I also have another chart in front of me which traces the yield on 3-month treasury bills from 1976 thru 1981. At the same point in time that M_{1B} started to fluctuate greatly, treasury bills started to show the same erratic behavior with rates fluctuating between 7 and 16%—what kind of consistent monetary policy can such behavior possibly demonstrate?

4. Mr. Volcker, it is not unusual for me to hear in Wyoming, as well as here, that the high interest rates are killing us, and that the person who is the most responsible for keeping them at those intolerable levels is a man I didn't even get the opportunity to vote for. Mr. Volcker, I am not suggesting that the Chairman of the Federal Reserve should be an elected office, but I wonder what your opinion would be of making the Chairman of the Federal Reserve a member of the President's cabinet

with the responsiblity to take those actions which the President feels are consistent with his or her economic program?

5. Mr. Volcker certainly the Congress has a responsibility ahead of it to deal with the budget and make significant progress in the projected deficits figures. However, if the Congress makes significant progress in reducing the deficit figures as you say we must, and I think we will, what assurance is there that your policies will not be so restrictive as to stifle any possible significant recovery by this economy?

Answer No. 1. The objective of the Administration's economic program announced February 18, 1981, is to support economic growth while reducing inflation. Recognizing the critical role of monetary policy in the fight against inflation, this program calls for a consistent policy of monetary restraint. The Federal Reserve's objectives for growth of money and credit in 1981 and those for this year—announced on February 10, 1982, in the Board's Monetary Policy Report to Congress—are consistent with the Administration's program for economic recovery. The objective of monetary policy is to slow the expansion of money over time to rates consistent with the needs of an economy growing in line with its productive potential at reasonably stable prices. But I should emphasize that a program of restrained money growth is not synonymous with a high interest rate policy. The level of interest rates, especially long-term rates, is influenced by a variety of factors besides the supply of money, including prominently expectations about inflation.

While recent credit market conditions have had a damping effect on economic activity, a relaxation of money growth would exacerbate—not cure—the problem. Economic theory and experience alike indicate that progress toward price stability cannot be obtained without adequate restraint on the growth of money and credit. Failure to persist in the effort to lower the trend of monetary growth would have long-lasting and damaging consequences for the performance of the economy. The recent improvement in inflation—which is beginning to be translated into expectations—would be reversed, with potentially adverse effects on financial markets, particularly long-term rates. Indeed, continuing doubts and skepticism that anti-inflation efforts will be carried through—especially in light of the large federal deficits expected in the coming years—is a significant factor exerting upward pressure on interest rates today. Thus, the Federal Reserve's announced policy of restraint on the growth of the monetary aggregates, rather than hindering the economic recovery program, is a key element in the nation's attempt to reduce inflation, restore greater stability to financial markets, and improve the prospects for sustained economic progress.

Answer No. 2. Let me first observe that your chart depicts money growth on a monthly basis, which I do not believe is a significant factor in economic performance or inflation. However, we are mindful of the need to understand the pattern of money growth over time and have done considerable research on the matter. A Federal Reserve staff study of the first year of the new monetary control procedures (February 1981) identified several factors which contribute to variability in short-term money growth. It was found, for example, that comparisons of money stock variability for different years are importantly affected by the seasonal adjustment process. Seasonal factors applied during the current year—and, to a lesser extent, in recent earlier years as well—are not able fully to reflect changing seasonal patterns. Annual reestimation of seasonal factors—as money supply data for subsequent years make possible better estimates of the changing seasonal patterns—gradually tends to smooth some of the initially observed variation in money.

Even after allowing for distorting effects of seasonal factors, there apparently has been a rise in the short-run variability of money growth since the introduction of the new operating procedures. Evidence suggests, however, that swings in monetary growth in the first year of the new control procedures importantly reflected large variations in money demand associated with the imposition and subsequent removal of the credit control program. Further, in early 1981, the rapid shifts of funds into the NOW accounts introduced nationwide at the end of 1980 significantly affected variability in M_{1B} growth. Finally, during the period since October 1979, the demand for money occasionally has been buffeted by the rapid but erratic pace of financial innovations, which have arisen as money holders have responded to high market interest rates by seeking ways to pare their transactions balances.

Apart from these special developments, movements in the money stock over short periods naturally reflect the underlying volatility in the public's demand for money. The enormous volume of transactions that occur each day in our complex economy, involving financial assets as well as goods and services, is associated with considerable short-run variation in measures of money. Efforts to eliminate such short-run fluctuations, which tend to be largely self-reversing, would necessarily be at the expense of even greater volatility in interest rates.

But to restate the more important point, there is no empirical evidence that month-to-month fluctuations have any significant impact on the course of the economy. In evaluating the experience with monetary control, the focus therefore should be on long-term trends. In this regard, the Federal Reserve has had a considerable degree of success, slowing the growth of M_1 over the past two years consistent with the needs of anti-inflation policy.

Answer No. 3. M_{1B} was introduced in February 1980 when the monetary aggregates were redefined. It differed from M_{1A} by the inclusion of other checkable deposits (OCD), containing interest-bearing NOW and similar accounts. Growth in OCD has significantly affected the growth of M_{1B} on several occasions both before 1980 and since. The major impact already has been referred to in the response to the previous question, namely the rapid growth following the nationwide authorization of NOW accounts at year-end 1980. In recognition of the public's adjustment to NOW accounts, the Federal Reserve published a "shift adjusted" M_{1B} in 1981, calculated as M_{1B} less estimated shifts into new NOW accounts from sources other than demand deposits.

Because M_{1B}, which as of January 1982 has been relabeled M_1, now has a substantial OCD component, it likely will respond somewhat differently to interest rates than it did when its OCD component was less important. Because OCD can serve as a savings medium as well as a medium of exchange, variations in savings preferences can affect the public's holdings of OCD. In particular, OCD—together with traditional savings deposits themselves and other liquid instruments—represent a more attractive temporary store of wealth in times of heightened uncertainties regarding the future course of interest rates or economic activity. For example, in the July to August 1980 period and again in the November 1981 to January 1982 period, OCD growth accelerated along with savings and certain other liquid assets. Thus it may be that the changing composition of M_1 has tended to make it more variable. In view of the changing nature of M_1, the Federal reserve monitors closely the behavior of each of its components.

The variations in interest rates and monetary growth you refer to do not indicate a lack of consistency in monetary policy. Rather, they primarily reflect variations in the amount of money demanded by the public and the accompanying financial market pressures implied by an effort to keep the money supply close to a targeted path. Thus, the sharp run-up in rates in late 1979 occurred as both M_1 and M_2 threatened to exceed the upper bounds of their growth rate ranges for that year. Subsequently, as the monetary aggregates began to decelerate, credit controls were introduced in March 1980. The profound effects on economic activity and financial conditions led both to sharply reduced demands for money and credit and to considerable downward pressure on interest rates. The extreme sharpness of the economic contraction at that time was followed by an unusually prompt and vigorous rebound in economic activity and demands for money and credit. As a result, the money stock began again to move rapidly toward the upper end of its target range. Policies to resist this movement were accompanied by upward movements in interest rates during the second half of 1980.

Interest rates began 1981 at record levels. However, shortly into the year money demands began to subside and financial market pressures eased for a time. A subsequent bulge in money in the second quarter resulted in a growth in required reserves that exceeded the growth of nonborrowed reserves provided by Federal Reserve open market operations, and short-term interest rates moved back toward their earlier highs. By mid-summer, demands for money and credit weakened, while the Federal Reserve provided reserves in an effort to maintain adequate monetary growth. Accordingly, interest rates declined until the final month of 1981, when money demand again picked up, apparently in part as a result of heightened precautionary motives.

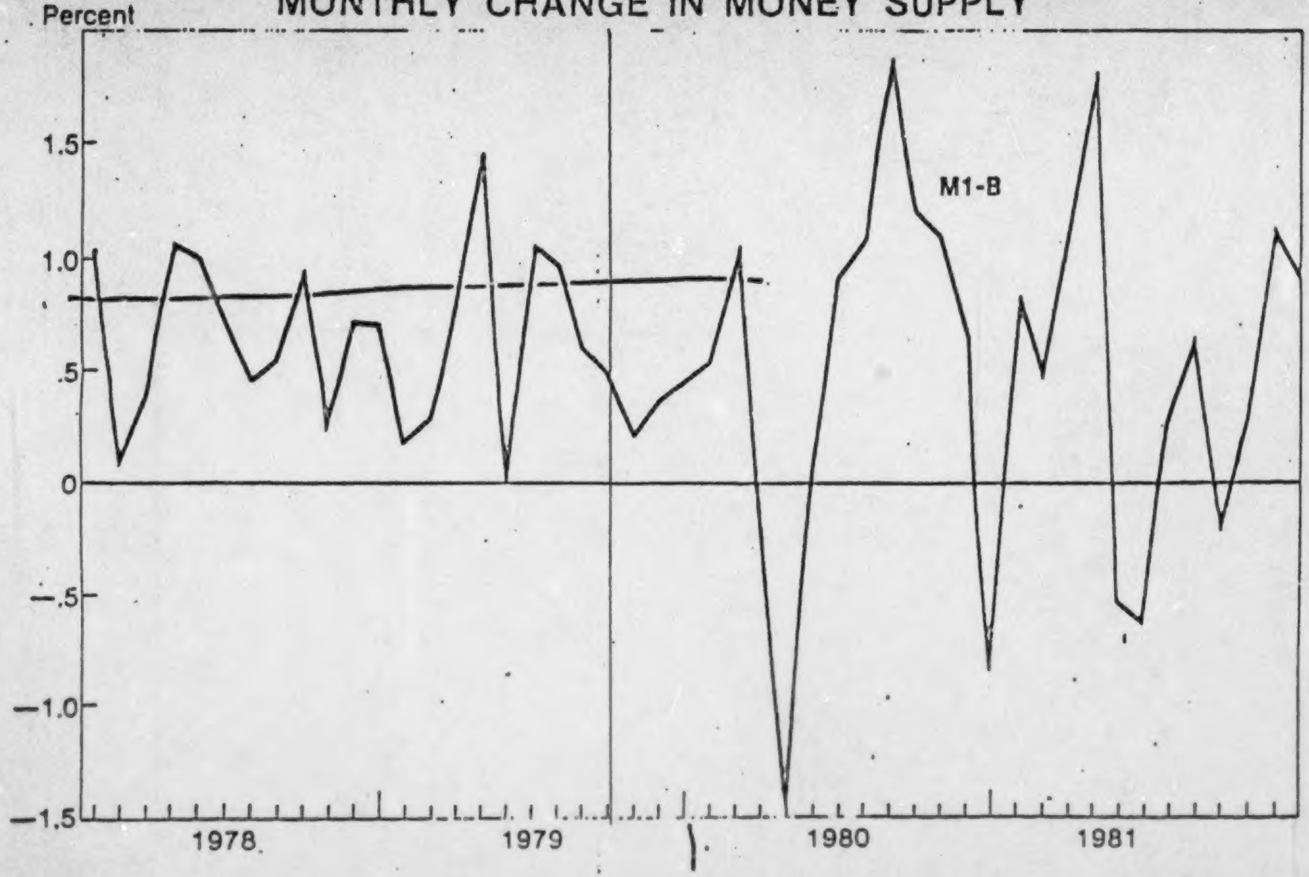
Answer No. 4. As you know, the Federal Reserve was created by the Congress in 1913 as an independent agency in order to insulate monetary policy decisions from short-term political pressures. One of the main ideas in the minds of the framers of the original Federal Reserve Act was that the System should be a distinctly nonpartisan organization whose functions are divorced from partisan political considerations.

Although the Federal Reserve, as an independent agency, is responsible for reaching judgments in the monetary policy area, the Board is accountable to the Congress and maintains close communications with both the Congress and the Administration. Designating the Chairman of the Federal Reserve a member of the President's cabinet, however, could result in some erosion of this carefully constructed independence—an independence that I regard as essential if monetary policy is to be free from day-to-day political pressures and play its proper role in achieving economic stability. There is also an issue here of credibility, which is a vital, even if intangible, component of successful monetary policy. We must be concerned about the market's perception of our will to continue a disciplined monetary policy, and this perception could be undermined by an erosion of the Fed's independence within the government.

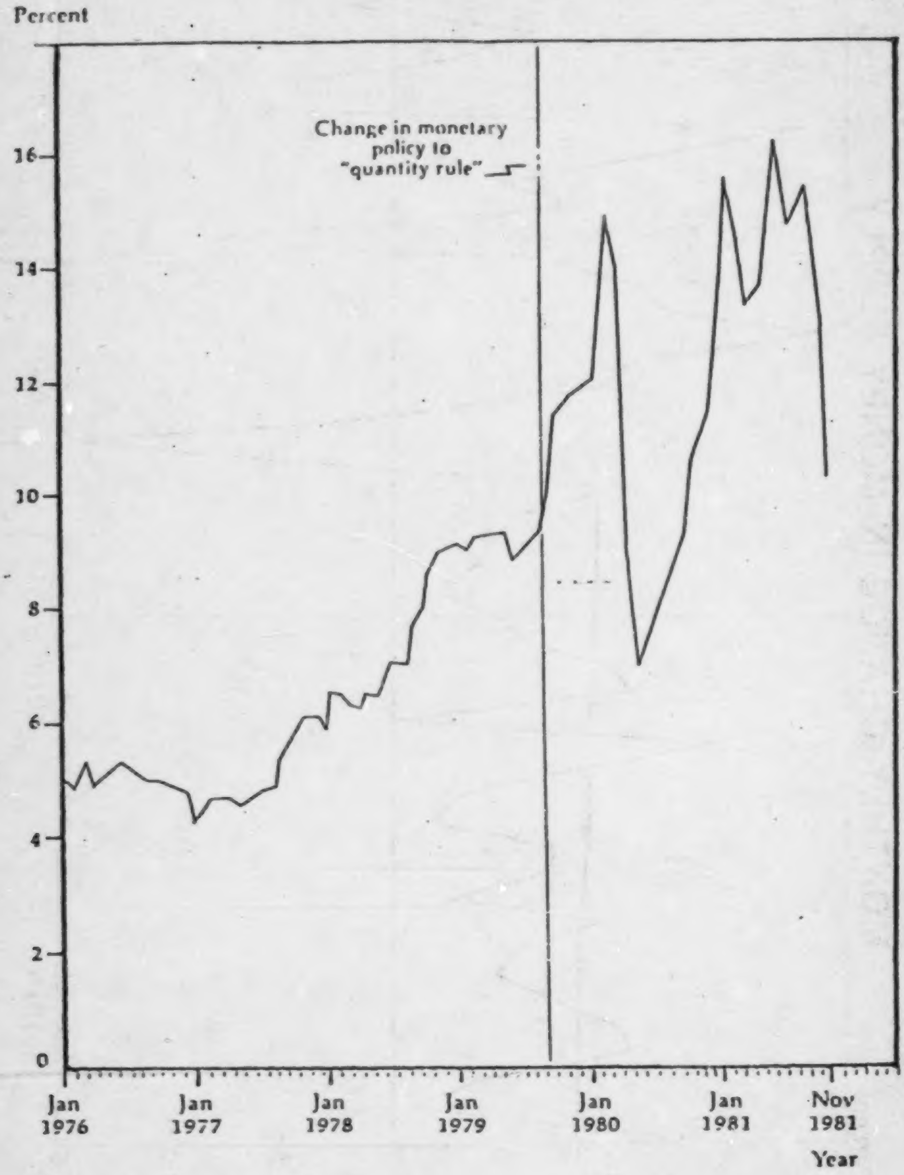
Answer No. 5. The central objective of monetary policy currently is to return the economy to growth in line with its productive potential at reasonably stable prices. For the past two years, in particular, Federal Reserve policy has been directed toward the achievement of this objective by slowing the growth of money over time. In my opinion, the prospects for inflation are now improving significantly, although the battle is far from won. Given these prospects for slowing of inflation, the monetary targets for 1982 will "leave room" for economic recovery later this year. Accelerating the growth of the money supply in an effort to bring interest rates down quickly runs the risks of rekindling inflationary expectations and therefore being self-defeating. In such an event, the "inflation premium" in interest rates would rise, and the progress on inflation itself could be reversed.

In regard to the longer-run period for which Congress will be attempting to control and reduce budget deficits, let me note again the scale of the problem. In the absence of deficit-reducing measures at least at large as the President has proposed, the unified deficits in fiscal year 1983 and 1984 are projected to be over 4 percent of GNP (that is, larger than the post-war record in the recession year of 1976) and over 20 percent of total gross saving provided by the private domestic, foreign, and state and local sectors combined. Potential deficits of this magnitude suggest an intense competition between the federal government and private borrowers for the limited pool of saving and, hence, continuing pressures of interest rates, especially on the assumption of renewed economic growth and recovery in private demand to finance business fixed investment, housing, and so forth. In contrast, a significant reduction in the deficit within the context of a moderate anti-inflationary monetary policy would result in more credit being available to the private sector at lower interest rates.

MONTHLY CHANGE IN MONEY SUPPLY



Yield on Three Month Treasury Bills
1976-1981



——— Yield on three-month treasury bills

The **Chairman**. Mr. Volcker, we thank you very much for your attendance this morning. And I assume that it is fair to say that we hope we will be seeing you again before the Committee. If inflation and interest rates drop too rapidly, we may have a hearing on why it happened. [Laughter.]

And I hope I am Chairman when that hearing is held.

Mr. **Volcker**. I would be delighted to return under those circumstances or any other, Mr. Chairman.

The **Chairman**. If it happens too fast, I am certain somebody is going to criticize it so we want to be prepared and we are already laying plans for the hearing.

Thank you very much.

[The prepared statement of Chairman Volcker follows:]

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

I appreciate this opportunity to participate in your hearings on the President's economic program. The responsibilities of the Federal Reserve are, of course, limited to monetary policy, but we must necessarily recognize the broad interrelationships among monetary and other policies bearing upon national economic performance. Your Committee has particular responsibility for initiating specific revenue and spending measures; in reaching your decisions, you must also take into account their implications for the overall fiscal position of the government and the implications for financial markets. It is at that point that our concerns intersect, and my comments this morning will be largely directed to that area.

I have often expressed my concern about the critical need to break the inflationary momentum that had come to grip the nation in the 1970's and spoken of the indispensable role that monetary policy has to play in that effort. At the same time, I have emphasized the extra difficulties that result from placing too heavy a burden on monetary policy alone in the fight on inflation -- difficulties manifested in exceptionally heavy pressures on financial markets and interest rates, and therefore on credit-dependent sectors of the economy.

Current developments both reflect needed progress on the inflation front and reinforce my concern about the burdens placed on monetary policy to bring about and sustain that progress. In the best of circumstances, ending an inflation, once it has become embedded in behavior and expectations, can be painful in the short run, however necessary that effort is to our future strength and prosperity. The hard fact is the economy is now in the grips of a second recession in as many years. Recent developments have some of the characteristics of earlier cyclical downturns. But the current recession has been superimposed on a pattern of stagnation extending over a number of years -- years characterized by a rising trend of unemployment, lagging productivity, and particularly strong pressures on the older industrial sectors and regions. And, even now, after months of rising unemployment, interest rates have remained painfully high, delaying recovery in some important sectors of the economy.

In broad terms, I don't think there is any great mystery as to why the economy and financial markets have behaved in this way. During the 1970's, inflation increasingly became viewed as a way of life, and in the process economic incentives were distorted and our productive energies sapped. As we lost our most important financial yardstick -- a stable dollar -- interest rates rose and became highly volatile. As monetary policy moved to deal more forcefully with the inflation -- particularly in a context of fiscal imbalance -- the strain on financial markets became more acute. But the alternative course of trying to accommodate to inflation by providing excessive monetary growth would offer no lasting relief -- and probably little respite even in the short run -- for that approach would only feed inflationary expectations and reinforce the reluctance of lenders to commit funds for any substantial period of time ahead.

Now we can see clear signs of progress on the inflation front. A reversal of the pattern of the inflation rate ratcheting higher in each successive economic cycle would be an event of profound importance, not least in encouraging a return to much lower and more stable interest rates. We cannot "prove" that we have yet turned that corner. Indeed, some of the progress against inflation reflects the more immediate and temporary effects of recession-weakened markets, the pressures of extraordinarily high interest rates on commodity and other sensitive prices, and recent surpluses in petroleum and grain production. But we are also seeing signs of potentially more lasting changes in attitudes of business and labor toward pricing, wage bargaining, and productivity. Not surprisingly, the effort is most clearly apparent in industries where costs and wages have been most out of line, where international competitive pressures are particularly intense, or where regulatory change has encouraged greater price competition. But, I believe the pattern is likely to spread, "building in" lower rates of increase in nominal wages and prices over time. And, as the inflationary and cost pressures ease, the economy can resume a healthy growth pattern, with greater job opportunities, increasing productivity, and higher real wages.

But if that bright prospect is to be achieved, we simply cannot afford now -- just as the disinflationary process is beginning to take hold and beginning to be believed -- to abandon our monetary vigilance. Past failures to "carry through" have left a legacy of skepticism and uncertainty among workers and businessmen, among consumers, and among participants in financial markets where lenders demand "inflation" and "uncertainty" premiums when committing their funds. Credibility in dealing with inflation will have to be earned by performance and persistence over time. Prudent fiscal and other policies must help in achieving that credibility. But I believe it is broadly and rightly recognized that, whatever those other policies, appropriate restraint on the expansion of money and credit will continue to be fundamental to restoring price stability.

As you know, I testified two weeks ago before the House and Senate Banking Committees to report the Federal Reserve's specific intentions with respect to money and credit growth for 1982. Without repeating the details, I'd like to highlight a few of the major points.

Developments during 1981 were broadly consistent with the continuing effort to reduce growth of money and credit to non-inflationary levels over time. There were, to be sure, some divergent movements among the various monetary and credit aggregates that we target. Those movements are largely explicable in terms of technological and regulatory change -- the introduction of NOW accounts nationwide, the enormous growth of money market funds, and other factors affecting the preferences of the public for different types of financial assets. Specifically, M1-B growth (adjusted for the estimated shift of funds into NOW accounts) decelerated further last year, averaging, over the year as a whole, a little more than 1 percent below the previous year -- the third consecutive year of lower growth. From the fourth quarter of 1980 to the fourth quarter of 1981, M1-B growth (adjusted) was 2.3 percent, a little more than 1 percentage point below the lower end of the target that we had indicated was desirable at mid-year. The growth of the broader aggregate M2 -- about 9-1/2 percent over the four quarter period -- was a bit higher than in 1980, partly reflecting the extraordinary growth in money market funds.

As you know, the money supply increased particularly sharply in the early weeks of 1982, following fairly large increases in November and December. Increases of that size are unusual when production and incomes are weak, and the recent rise appears to be related in considerable part to the desire of individuals to place marginally more of their assets in highly liquid form. Interest rates, after falling sharply last fall, retraced part of that decline in January and early February, partly because the rising money supply was reflected in renewed pressure on bank reserve positions. More recently, monetary growth appears to be moderating, and bond markets have rallied.

These recent movements, in my mind, emphasize again two relevant points in assessing our monetary targets and their implications. First, in a large and complex economy, short-term fluctuations in money supply data -- for a month or even a quarter, and much more so from week to week -- can be anticipated as consumers and businesses adjust their cash holdings. So long as the trend is appropriate, those short-term fluctuations should have no important implication for economic activity or inflation.

Second and more fundamentally, our targets are, by design, limited to amounts necessary to finance real growth in a framework of declining inflation. The stronger the inflationary momentum, and the more pressure on credit markets from other directions, the greater the risk that high interest rates will squeeze out housing, investment, and other private activity supported by borrowing.

We believe the targets for 1982 established this month (reaffirming tentative targets set out last July) will be consistent with recovery in business activity over the second half of the year. Our target range for M1 of 2-1/2 to 5-1/2 percent is consistent with growth in money over the year as a whole larger than during 1981, and the Federal Open Market Committee has suggested that, as things now stand, growth in the upper part of the range would be acceptable. The FOMC also suggested M2 growth toward the upper end of its 6-9 percent range (the same as last year) would also be acceptable. But these ranges also imply a "tight fit," in the sense they are predicated on the assumption and prospect of a further decline in the rate of inflation.

The fact is that consolidating and extending our progress on inflation will require continuing restraint on monetary growth, and we intend to maintain the necessary degree of restraint.

That restraint, by providing assurance that inflation will continue to decline, should over time be a powerful influence in bringing down interest rates as well, particularly in the long-term area. Indeed, prospects for any lasting relaxation of interest rate pressures would be dim without the continuing monetary discipline that success against inflation requires.

For the more immediate future, interest rate prospects depend crucially on other factors as well, and I am fully aware that interest rates are vitally important to the timing, strength, and sustainability of economic recovery. The most important of those "other" factors is surely the outlook for the Federal deficit, and it is a factor directly within your own purview.

As you know, this year, fiscal 1982, we will have a very large Federal deficit -- on the order of $100 billion. To a considerable extent, that deficit is a reflection of the recession, as it reduces revenues and raises outlays. In the particular circumstances of today, the current deficit, to a large degree, acts as an "automatic stabilizer" for the economy. The financing load should be manageable in a context of reduced credit demands by other sectors.

As we look ahead to 1983 and beyond, the situation is quite different, and that is the source of my concern about the budgetary situation. What is so disturbing is that the current services budget (taking account of the Administration's defense program) shows a sharply rising deficit, even if we assume revenues are lifted and spending restrained by rather strong recovery. All the estimates before you, by the Administration, by the Congressional Budget Office, or by private forecasters, point in the same direction. In the absence of action to close the potential gap, the deficit will rise to about $150 billion or more in fiscal 1983, and to still larger amounts in later years. Looking at the same situation in another way, even if we assumed the unemployment rate would soon drop back to six percent or so -- about the level of the best recent years -- we would be faced with large and rising deficits unless strong new measures are taken to contain them.

In recognition of this outlook, the Administration has, as you know, proposed substantial measures to reduce the potential deficit for fiscal 1983, and the years beyond. The emphasis is on spending reductions, but some revenue measures are also proposed. That program is estimated to reduce the projected fiscal gap by $56 billion in 1983 and $84 billion in 1984. If enacted, as proposed, it would go a very considerable way toward dealing with the fiscal problem.

As you consider those and other proposals, I must emphasize the threat that, unless substantial budgetary actions are undertaken, private borrowers would be squeezed out of the market, with adverse consequences for homebuilding, for business investment, and for other credit-dependent sectors. In other words, the budgetary outlook, as it stands, does not seem to me consistent with the expansion in private investment we seek, and have sought to encourage through tax reduction and other measures.

The problem is not simply one for the future -- for 1983 and 1984 and beyond. Financial markets constantly look ahead -- any lender or borrower tries to anticipate and "discount" what lies ahead. Anticipations of a future "squeeze" are translated into present high interest rates, into a desire to "stay short" in lending, into a reluctance to set into motion plans to build and to invest. Moreover, the deep-seated public instinct that sustained large deficits will lead, sooner or later, to pressure to create more money to finance those deficits, or will otherwise stimulate inflation, undercuts the effort to restore stability.

I would also point out that, even with measures as large as those proposed by the Administration, we would be left with historically high deficits in relation to GNP or our probable savings potential, as the projected recovery proceeded. And those projections have little margin for misjudgment of the underlying trend in spending or revenues, in interest rates, in the inflation rate and the like -- areas where any projection has an element of uncertainty. I note, in that respect, that projections of the existing budgetary gap by the Congressional Budget Office run somewhat higher than those of the Administration.

The potential for continuing squeeze on financial markets could be alleviated by increases in business and personal saving. Such saving has been abysmally low in recent years. Greater price stability, positive real interest rates, and the tax measures introduced last year, all should work in the direction of greater savings. But to count on a dramatically large increase in savings to "bail" us out of the budgetary problem would be to miss the point, at best. We need larger saving to finance higher levels of business investment and housing construction; we cannot afford to have it dissipated in financing prolonged excessive budget deficits -- deficits that, as matters stand, would absorb, or more than absorb, a reasonable projection of increased savings.

Given the nature of the problem before us, and the clear risks of underestimating the size of the budgetary problem, I can only conclude that the Congress should set its sights for still larger budgetary savings, keeping in mind the widening gap now projected beyond fiscal 1983.

Credible steps to assure substantially declining Federal deficits as the economy expands, looking toward balance as we restore satisfactory levels of unemployment, would be enormously helpful in resolving some of the problems in our financial markets today. Indeed, such action could have a galvanizing effect in bringing about lower interest rates because it is concern about the budgetary prospects that preoccupies the thinking of many potential investors in the market today.

In carrying the primary responsibility for tax legislation and for certain large spending programs, your Committee has the excruciating job of translating general budgetary objectives into concrete legislation. You must make choices involving social, national security, and programmatic considerations far beyond the purview of the Federal Reserve or my competence. As a purely economic matter, I do believe that, in general, lower taxes -- particularly lower marginal income tax rates -- will permit the private economy to perform more effectively, tending to increase incentives and to reduce distortions. From that standpoint, spending control clearly deserves priority. But to the extent the needed job cannot be done by expenditure control alone, I see no alternative to considering new sources of revenue.

The difficult economic circumstances of today should not blind us to the fact that we have much upon which to build. We can see the tangible progress against inflation. The Administration and the Congress have taken action to spur productivity, work, and savings through the tax system. The inexorable upward trend in spending has been bent lower. Regulatory reform is underway.

From that perspective, what we need is not any basic change in direction, but a sense of urgency and persistence in "carrying through." That has clear implications for continued discipline in monetary policy. And it has direct implications for dealing with the budgetary problem that looms so large before you.

Seldom, in my experience, has the challenge been so clear for all to see. And seldom has there been so strong a consensus on the need to meet it with bold measures. It is those facts that give me confidence that you and your colleagues, working with the Administration, will find the way to reconcile the competing priorities among the particulars of spending and revenue decisions in a way consistent with needed reduction in the deficit. The quicker that can be done, the brighter, in my judgment, will be the outlook for the economy.

Monetary Policy Objectives for 1982

Summary of Report to the Congress on Monetary Policy pursuant to the Full Employment and Balanced Growth Act of 1978. With excerpts of testimony presented by Paul A. Volcker, Chairman, Federal Reserve Board, February 10, 1982.

Contents

Section Page

Monetary Policy in 1982 2

The Federal Reserve's Objectives for the Growth of Money and Credit 2

M1 Growth 3

Growth in the Other Aggregates 3

The Outlook for the Economy in 1982 4

Prospects for Economic Recovery 4

Economic Projections 5

Monetary Policy and the Performance of the Economy in 1981 6

The Growth of Money and Credit in 1981 6

Economic Performance in 1981 8

Excerpts from testimony of Paul A. Volcker, Chairman, Federal Reserve Board 12

Monetary Policy in 1982

The Federal Reserve's Objectives for the Growth of Money and Credit

The Federal Reserve remains committed to restrained growth in money and credit to exert continuing downward pressure on the rate of inflation. Such a policy is essential if the groundwork is to be laid for sustained economic expansion.

There was a distinct slowing of inflation during 1981, and the prospects for further progress are good. Failure to persist in the effort to maintain this improvement would have long-lasting and damaging consequences; inflationary expectations would again deteriorate, with potentially adverse effects on financial markets, particularly long-term rates, and the next effort to curb inflation would be associated with still greater hardship.

Progress toward price stability can be achieved most effectively—and with the least amount of economic disruption—through a combination of monetary, fiscal, regulatory and other economic policies. But it is quite clear that inflation cannot persist over an extended period unless financed by excessive growth of money.

Targets for money growth have therefore been set with the aim of slowing the expansion over time to rates consistent with the needs of an economy growing in line with its productive potential at reasonably stable prices. The speed with which the trend of money growth can be lowered without unduly disturbing effects on short-run economic performance depends, in part, on the credibility of anti-inflation policies and their effects on price expectations, as well as on other forces influencing interest rates and credit market demands, including importantly the fiscal position of the federal government.

Given these considerations, the Federal Open Market Committee reaffirmed the ranges of monetary expansion shown in the table below for the year ending in the fourth quarter of 1982. These ranges are the same as those tentatively set last July for 1982 and confirm the Federal Reserve's commitment to reduce inflationary forces.

Ranges of Monetary Growth[1]

1982 Projected		1981 Actual	
M1*	2½ to 5½ percent	M1B	5.0 percent
		M1B (shift adjusted)	2.3 pecent[2]
M2	6 to 9 percent	M2	9.4 percent
M3	6½ to 9½ percent	M3	11.4 percent
Commercial Bank Credit[3]	6 to 9 percent	Commercial Bank Credit[4]	8.8 percent

*Formerly M1B. See footnotes page 11.

M1 Growth

At its meeting in February, the Committee recognized that the recent rapid increases placed M1 in January well above the average level during the fourth quarter of 1981, the conventional base for the new target. Experience has shown that M1 growth can fluctuate rather sharply over short periods and these movements may be at least partially reversed fairly quickly. The available analysis suggested that the recent increase reflected in part some temporary factors, rather than signalling a basic change in the amount of money needed to finance nominal GNP growth.

During 1981, M1B (shift adjusted) rose relatively slowly in relation to nominal GNP. On the assumption this relationship is likely to be more normal in 1982, and given the relatively low base for the M1B range, the Committee felt that growth in M1 (formerly M1B)[1] this year in the upper half of its range would be acceptable. At the same time, the FOMC elected to retain the 2½ percent lower bound for M1 growth tentatively set last July in recognition of the possibility that financial innovations—especially techniques for economizing on the use of checking account balances included in M1—could accelerate, with restraining effects on M1 growth.

Growth in the Other Aggregates

The actual and potential effects on M1 of ongoing changes in financial technology and the greater availability of a wide variety of money-like instruments strongly suggest the need to give careful attention to developments in the broader money measures. The range for M2 growth is the same as in 1981, when actual growth slightly exceeded the upper bound of the range. The Committee felt that M2 growth in 1982 would be somewhat below the 1981 pace, although probably in the upper part of the range. However, should personal savings—responding to recent changes in tax law or other influences—grow substantially more rapidly in relation to income than now anticipated, or should depository institutions attract an exceptionally large inflow to IRA accounts from sources outside M2, growth of M2 might appropriately reach—or even slightly exceed—the upper end of the range.

The 1982 ranges for M3 and bank credit are unchanged from those for 1981. These aggregates again will be influenced importantly by the degree to which credit demands tend to be focused in short-term borrowing and are funded at home or abroad.

The Outlook for the Economy in 1982

Prospects for Economic Recovery

Economic activity still appeared to be contracting in early February: industrial production and employment certainly declined further in January, with the extent of the fall worsened by exceptionally bad winter storms. Demand in the key sectors that had led the decline—housing and consumer spending—showed some signs of leveling off as the year began, and the recent cuts in production likely have helped to relieve some of the remaining inventory imbalances. It would appear that the economy is in the process of bottoming out and a perceptible recovery in business activity should be underway by midyear.

One element supporting final demands in the economy is the federal government. Part of the recent expansion in the deficit reflects the cushioning effects of reduced taxes and increased government expenditures that result from declining income growth and rising unemployment. In addition, however, the build-up in defense spending is a continuing source of stimulus. The second phase of the tax reductions scheduled for July will provide another expansionary impetus to the economy. At the same time the deficit—particularly if expected to continue at exceptionally high levels in later years—adversely influences current financial market conditions.

The Federal Reserve's objectives for money growth in 1982 are consistent with recovery in economic activity. The expansion is likely to be concentrated initially in consumer spending. Given the substantial margin of excess capacity, outlays for business fixed investment may remain weak, particularly if long-term interest rates continue to fluctuate near their current high levels. A continuation of high levels of long-term rates also would inhibit the recovery in residential housing, although demographic factors will continue to buttress demands in that sector.

The effort to deal with inflation is at a critical juncture. The upward trend in inflation clearly has been halted and the process of reversal is underway. There are signs that price setting, wage bargaining, and personal spending decisions are being made that will serve to moderate, rather than intensify, inflationary pressures. Nonetheless, the behavior of financial markets and other evidence strongly suggest that there continues to be considerable skepticism that progress in reducing inflation will be maintained. Lasting improvement in financial markets—particularly for longer-term instruments—is dependent on confidence that progress against inflation will continue; looming federal deficits have served to shake that confidence. Prospects for lower interest rates and for sustaining recovery over a long period—indeed for the timing of recovery—are thus tied to prospects for a more stable price level.

Economic Projections

Given the current circumstances and in light of the monetary targets for the coming year, the individual members of the FOMC have projected economic performance in 1982 that generally falls within the ranges listed in the table below.

The members of the FOMC expect inflation to continue to moderate in 1982. At the same time, real activity is expected to accelerate with most of the growth coming in the second half of the year. With inflation continuing to be substantial and the prospect that the federal budget deficit will remain large even as the recovery gathers momentum, demands for credit should intensify as the year progresses. In these circumstances, the recovery is likely to be somewhat restrained, with unemployment probably substantial at year-end 1982.

The projections generally encompass those that underlie the Administration's recent budget proposals. The consensus view of the FOMC anticipates an improvement in inflation during 1982 comparable with the Administration's, as well as a similar outlook for the labor market. The Administration's projection for real growth falls at the high end of the FOMC consensus. Should prices and wages respond more rapidly to anti-inflation policies than historical experience suggests, or should more favorable productivity trends develop, then the recovery could be faster without adverse pressures developing on prices, wages, and interest rates.

Economic Projections for 1982

		1981 Actual	1982 Projected	
			FOMC Members	Administration
Changes, fourth quarter to fourth quarter, percent	Nominal GNP	9.3	8 to 10½	10.4
	Real GNP	0.7	½ to 3	3.0
	GNP Deflator	8.6	6½ to 7¾	7.2
Average level in the fourth quarter, percent	Unemployment Rate	8.3	8¼ to 9½	8.4

Monetary Policy and the Performance of the Economy in 1981

The Growth of Money and Credit in 1981

In its report to Congress last February, the Board of Governors indicated that the System intended to maintain restraint on the expansion of money and credit in 1981. The specific ranges chosen by the FOMC for the various monetary aggregates anticipated a deceleration in monetary growth that would encourage further improvement in price performance. Measured from the fourth quarter of 1980 to the fourth quarter of 1981, the ranges adopted are shown in the table below.

Review of the Aggregates

Even after accounting for shifts into NOW accounts, and reflecting the rapid pace of institutional change in financial markets, the behavior of the aggregates in 1981 was more divergent than anticipated. Average growth in adjusted M1B over the first half of 1981 was well below that which would have been expected on the basis of historical relationships among money, GNP, and interest rates. On the other hand, despite the weakness in M1B, the broader aggregates expanded quite rapidly in early 1981. M2 growth over the first half was near the upper end of its annual range, while the expansion of M3 and bank credit placed these aggregates above the upper bounds of their ranges at midyear.

After reassessing its objectives for 1981 at midyear, the FOMC elected to leave unchanged the previously established ranges for the aggregates. However, in light of the reduced growth in M1-type balances over the first half of the year—with indications that this weakness might reflect a lasting change in cash management practices of individuals and businesses related to the growth of alternative means of holding highly liquid funds—and given the relatively strong growth of the broader aggregates, the FOMC anticipated that growth of M1B might likely and desirably end the year near the lower bound of its annual range. At the same time, the FOMC indicated that M2 and M3 might well end the year around the upper ends of their ranges. This expectation also reflected the possibility that regulatory and legislative actions as well as the popularity of money market mutual funds might intensify the public's preference to hold assets encompassed in the broader aggregates.

The table on the next page puts the performance of the aggregates during 1981 into a somewhat longer-term perspective, showing two measures of annual growth. In both cases, a marked deceleration in M1B is apparent since 1978. The table also clearly illustrates that growth rates for the broader aggregates have been maintained around a higher level

Monetary Growth 1981

	1981 Ranges	1981 Actual	1981 Q4 Levels*
M1B	6 to 8½ percent	5.0 percent	436.7
M1B (shift-adjusted)	3½ to 6 percent	2.3 percent	425.3
M2	6 to 9 percent	9.4 percent	1806.9
M3	6½ to 9½ percent	11.4 percent	2171.0
Bank Credit	6 to 9 percent	8.8 percent[4]	1320.5[6]

*Billions of dollars, seasonally adjusted.

Growth of Money and Bank Credit (percentage changes)

	Year	M1B[3]	M2	M3	Bank Credit
Fourth quarter to fourth quarter	1978	8.3	8.3	11.3	13.3
	1979	7.5	8.4	9.8	12.6
	1980	6.6	9.1	9.9	8.0
	1981	2.3	9.4	11.4	8.8[4]
Annual average to annual average	1978	8.2	8.8	11.8	12.4
	1979	7.7	8.5	10.3	13.5
	1980	5.9	8.3	9.3	8.5
	1981	4.7	9.8	11.6	9.4[4]

and larger divergences have developed from M1B growth. In considerable part, these differences can be explained by structural changes in financial markets.

Changing Financial Practices

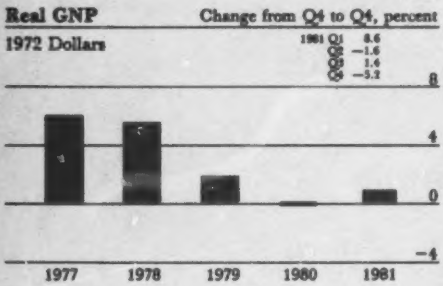
As indicated, the growth of the narrow aggregates adjusted for shifts into NOW accounts was low in 1981 compared with the other aggregates and also in relation to income and interest rates. Continued high interest rates provided a substantial incentive for businesses to pare narrow money balances and to make increasingly widespread use of sophisticated cash management techniques. At the same time, explosive growth of money market mutual funds (MMMFs) appeared to prompt households to minimize checking account balances; the broader availability of NOW accounts also may have prompted them to reconsider the way they handle cash assets.

Likewise, the strong growth of M2 last year reflected changing financial practices. Money market funds and instruments offered by depository institutions that pay market-related interest rates have been accounting for an increasing proportion of M2, as such assets have become much more competitive with open market instruments. Indeed, the attractiveness of small time deposits was enhanced last year by the liberalization of the interest rate ceilings on small savers certificates and, late in the year, by the introduction of all savers certificates. Even so, two-thirds of the increase in the nontransactions component of M2 was accounted for by money market mutual funds which grew 140 percent last year.

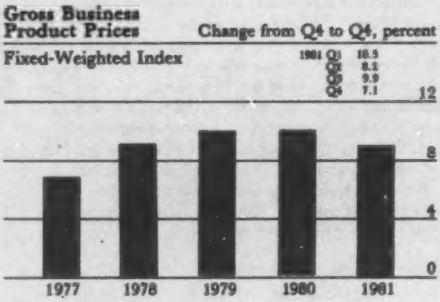
Economic Performance in 1981

The economy was growing rapidly as 1981 began, continuing the sharp cyclical rebound that started in mid-1980. Activity leveled out during the spring and summer, however, and it fell in the final quarter of the year. As a result, the rate of production of goods and services—real GNP—was only slightly higher at the end of 1981 than it had been a year earlier. With the weakening of output late in the year, the margin of unutilized plant capacity widened and the unemployment rate rose sharply.

While economic activity was disappointing last year, there were emerging signs of progress in retarding inflationary pressures. As 1981 progressed there also were indications of an easing in wage inflation, particularly in some key pattern-setting industries.


Real GNP Change from Q4 to Q4, percent

1972 Dollars


Gross Business Product Prices Change from Q4 to Q4, percent

Fixed-Weighted Index

Slowing of Inflation

The trend in inflation improved noticeably during 1981, and by year-end virtually all aggregate price indexes were advancing well below double-digit rates for the first time since 1978. The consumer price index rose 8.9 percent over the course of 1981, down from the nearly 13 percent average rate in 1979 and 1980. Important factors in the slowing of inflation were exceptionally favorable agricultural supplies and declines, after the first quarter, in world oil prices. Inflation in areas other than food and energy—particularly consumer commodities and capital equipment—also began to abate, although price pressures in the consumer service sector persisted. As the year progressed, surveys of inflation expectations suggested that the inflationary psychology, which had permeated many aspects of economic behavior in earlier years, appeared to be subsiding.

Credit Markets

On balance, short-term interest rates—although quite volatile and at record highs as 1981 began—moved down considerably over the course of the year. In contrast, long-term rates rose substantially. The pressure on long-term rates appeared to reflect a combination of factors. Anticipation that continued large federal budget deficits would clash with private credit demands, particularly as the economy expanded, were a continuing strong investor concern. Despite substantial reductions in the growth of many federal spending programs, federal borrowing in calendar year 1981 siphoned off roughly a quarter of the total funds available to domestic nonfinancial borrowers. Also in the background were continuing doubts and skepticism that anti-inflation programs would be carried through.

Housing Market

The tensions in credit markets in 1981 had their greatest impact on household capital formation. Housing construction fell to its lowest level in the postwar period; only 1.1 million new housing units were started in 1981. The average closing rate on mortgages for new homes was 15.3 percent in the fourth quarter of 1981, up from 12.6 percent a year earlier. High prices also adversely affected the ability of those seeking new homes to afford the monthly payments. Although house prices changed little in 1981, over the preceding 5 years prices of new and existing homes had risen half again as fast as the overall rate of inflation. As a result, the share of average family disposable income needed to service the monthly payment on a typical new mortgage rose from 21 percent in 1976 to nearly 40 percent last year.

Labor Market

Employment grew at a moderate rate during the first three quarters of 1981 and the unemployment rate edged down. As economic activity began to contract in the autumn, the demand for labor fell sharply and the unemployment rate climbed to 8.8 percent in December—only fractionally below its postwar high. The unemployment rate of adult men jumped to a postwar record of 7.9 percent in December 1981.

Labor productivity (output per hour worked) rose at a 1¼ percent annual rate in the first three quarters of 1981. However, output fell more than employment in the fourth quarter and productivity declined, offsetting gains earlier in the year. Averaging across short-run cyclical movements, productivity has shown little improvement in recent years and thus has provided virtually no offset to the impact of rapidly rising compensation on unit labor costs.

Compensation and wage increases did decelerate during 1981, with steady progress throughout the year. Also, by the second half of 1981, changes in traditional wage-setting practices were underway: management and workers alike began to reconsider planned wage adjustments; some expiring contracts were renegotiated well in advance of termination dates; and labor agreements at a number of firms were modified in an effort to ease cost pressures and to enable them to compete more effectively. These adjustments, coupled with the progress seen in reducing inflation during 1981, suggest that the nation's anti-inflation policies have set the stage for a sustained unwinding of wage and price increases.

Footnotes

1. The objective for growth of narrowly defined money over 1982 is set in terms of M1 only. Based on a variety of evidence suggesting that the bulk of the shift to NOW accounts had occurred by late 1981, the Federal Reserve is publishing only a single M1 figure in 1982 with the same coverage as the former M1B.

M1 is currency held by the public, plus traveler's checks, plus demand deposits at commercial banks net of deposits due to foreign commercial banks and official institutions less cash items in the process of collection and Federal Reserve float, plus other checkable deposits (i.e., negotiable order of withdrawal accounts, accounts subject to automatic transfer service, credit union share draft balances, and demand deposits at thrift institutions).

M2 is M1 plus savings and small denomination time deposits (including retail RPs) at all depository institutions, shares in non-institutional money market mutual funds (MMMFs), overnight repurchase agreements (RPs) issued by commercial banks, and overnight Eurodollar deposits held by U.S. residents at Carribean branches of U.S. banks.

M3 is M2 plus large time deposits at all depository institutions and large denomination term RPs issued by commercial banks and savings and loan associations, and shares in institution-only MMMFs.

Bank credit is total loans and investments of commercial banks.

2. M1B velocity, before shift adjustment, rose at a rate closer to historical experience. However, the shift of funds from saving accounts or other sources of funds not included in measures of the narrow money supply temporarily depressed the velocity figure, particularly early in the year.

3. Because of the introduction of International Banking Facilities, the bank credit data beginning in December 1981 are not comparable to earlier data. Thus, the targets for 1982 are in terms of growth from the average of December 1981 and January 1982 to the average level in the fourth quarter of 1982.

4. December level used for calculating 1981 growth rates for bank credit incorporates an adjustment to abstract from the shifting of assets from U.S. banking offices to International Banking Facilities.

5. Growth rate for 1980 and 1981 adjusted for shifts to other checkable deposit accounts since the end of the preceding year.

6. Level for December 1981. Because of the introduction of International Banking Facilities, this figure is not comparable to earlier data. January 1982 level is not yet available

A copy of the full Report to Congress may be obtained from Publications Services, Board of Governors, Washington, D.C. 20551.

Excerpts from Testimony of Paul A. Volcker, Chairman, Federal Reserve Board

I have submitted for the record the official report from the Board in accordance with the Humphrey-Hawkins Act. I would like to offer some more personal views on the problems—and equally important, the opportunities—that are before us.

As you know, the economy has been in recession for some months. The recession has some of the characteristics of earlier downturns. But it seems to me plainly wrong to think of the current state of the economy as simply reflecting "another" recession.

Rather, we are seeing the culmination of a much longer period of unsatisfactory economic performance extending well back into the 1970's—performance marked by poor productivity, growing unemployment, much higher interest rates, and pressures on the real earnings of the average citizen and on the real profits of our businesses.

A number of factors have contributed to that deterioration in our performance, not all of them completely understood. But one pervasive element—an element particularly relevant to monetary policy—stands out: we found ourselves in the midst of the most prolonged inflation in our history, and that inflationary process had come to feed on itself. Incentives were distorted. Too much of the energy of our citizens was directed toward seeking protection from future price increases and toward speculative activity, and too little toward production. Increasingly depressed and volatile capital markets reflected the uncertainties. Effective tax rates increased as inflation carried taxpayers into higher brackets. But, in a sluggish economy, those revenues did not keep up with our spending plans and programs.

Against that background, the notion that we might comfortably live with inflation—or that we could accept inflation in the interest of strong growth—was exposed as an illusion. I believe it is fair to say a clear national consensus emerged that turning back inflation had to be a top priority of economic policy—that a stable dollar is a necessary part of the foundation of a strong economy.

Monetary policy has a key role to play in restoring that stability, and our policies are directed to that end. But recent developments have confirmed again that ending an inflation, once it has become deeply seated in expectations and behavior, is not a simple and painless process. The problems can be aggravated if too much of the burden rests on one instrument of policy. And the effort to restore stability will be more difficult to the extent policies feed skepticism and uncertainty about whether the effort will be sustained—a skepticism rooted in past failures to "carry through." Monetary, fiscal, and other public policies are constantly scrutinized—in financial markets and elsewhere—to detect any signs of weakening in commitment to deal with inflation. To speed the transition to lower interest rates and healthier capital markets, to reduce the costly elements of anticipated inflation built into wage and price contracts, to permit more confident planning for the future—in fact, to lay the base for *sustained* recovery—credibility in dealing with inflation has to be earned by performance and persistence.

That, essentially, is what public policy—and monetary policy in particular—has been about for some time, and there are now signs of real progress on the inflation front. That progress is reflected to greater or lesser degree in all the widely used inflation indices. Consumer prices rose 8.9 percent last year, 3½ percentage points less than the 1980 peak, and the inflation rate seemed to be trending lower still as the year ended. Finished goods producer prices have had an average increase at an annual rate of only about 4 percent for six months. Expectations cannot be so easily measured, but earlier fears that inflation might rapidly accelerate have plainly dissipated.

Those gains, to be sure, have elements that may not be lasting. Some prices are depressed by recession-weakened markets, and some by the pressures of high interest rates on inventories and speculative positions; exceptionally good crops last year have held food prices down; and surpluses have emerged in oil markets, following the enormous price increases of earlier years.

But we also see evidence of potentially more lasting changes in the trend of costs as management and labor in key industries come to grips with competitively damaging productivity and wage trends. I am aware that this process has just begun, and it has been centered largely in areas where competitive pressures are most intense. But as the emerging patterns spread, we will have succeeded in establishing one of the major elements for success in the fight against inflation and for reconciling, as we must, a return to greater price stability with growth, reduced unemployment, and higher real wages.

I am acutely aware that progress on the inflation front has been accompanied by historically high levels of interest rates and heavy strains on financial markets. Those sectors of the economy particularly dependent on borrowing—especially long-term borrowing—have been hard hit.

It would be simplistic to cite high interest rates as the sole cause of the difficulties in these vulnerable sectors. Part of the problem arises from other, and longer-term, factors, themselves associated with the inflationary process. In housing, for example, we have had a decade of increases in prices of homes almost double the rate of inflation in the economy generally and well in excess of the rise in average family income. "Sticker shock" still seems to be the major deterrent to new car sales as the industry comes to grips with long developing competitive and regulatory problems and the enormous challenge of adapting to the higher price of gasoline.

In the best of circumstances, coping with deep-seated inflation would pose difficulties. At the same time, we have had to adjust to the huge increases in the price of energy, to meet the need for a stronger defense, and to deal with the drag on incentives and investment resulting from rising marginal tax rates. All of that implies massive economic adjustments, the threat of a growing fiscal imbalance, and a difficult transition period. The high level of unemployment generally, and particularly distressing conditions in some of our older industrial centers, are one symptom. Lasting progress toward price stability—and other needed adjustments—cannot be built on prolonged stagnation, rising unemployment, and slow growth. The relevant question is not whether current conditions are satisfactory or tolerable—they obviously are not. It is whether our policies, and our policy mix, promise to achieve the needed results over time.

It is against that background that I review monetary policy last year and discuss our intentions for 1982 in my official report...

• • • • • • •

Consolidating and extending the heartening progress on inflation will require continuing restraint on monetary growth, and we intend to maintain the necessary degree of restraint. The monetary growth ranges specified are, we believe, consistent with an economic recovery later this year, although we do not anticipate, by historical standards, a sharp "snap back." What is more important is that the recovery have a firm foundation—that it be sustained over a long period. There will be more room for real growth—and much better prospects for sustaining that growth over many years—the greater the progress on inflation...

Today, we are acutely aware of disturbed capital markets, high interest rates, economic slack, and a poor productivity record. But, when the economy begins to expand, productivity should rise; tax and other measures already in place or under way should help reinforce a better trend. Productivity growth, in turn, will permit prices to rise more slowly than wages—more modest wage and salary increases in dollars will then be consistent with more growth in real earnings, encouraging further moderation in wage demands and sustaining the disinflationary process. As confidence returns to securities markets, prices of bonds and stocks should rise, and lower interest rates and more favorable capital market conditions will in turn support the continuing growth in investment and productivity. With appropriate budgetary and monetary discipline, the process could be sustained for years.

That is not an impossible vision...From the standpoint of public policy, much of the groundwork has been laid. I have spoken of the key role for monetary policy, and of our record and intentions in that regard. The tax program enacted last year can, in the right context, have favorable effects on incentives and on investment. The excessive burden of regulation is being addressed...I have referred on many occasions to the key importance of winding down the cost and wage pressures that tend to keep the inflationary momentum going. The process appears to be starting, and the faster it takes hold the better the outlook for growth and reduced unemployment. But, clearly, prospects for early and sustained expansion—an expansion that can be broadly shared by industries now severely depressed—is dependent on access to capital and credit on more favorable terms. Pumping up the money supply cannot be the answer to that problem—excessive money and the inflation it breeds are enemies of the real savings needed to finance investment.

What we can do is relieve the concerns the markets understandably have—concerns reflected so strongly in the budgetary documents before you from both the Administration and your own Budget Office. *Without* action to cut spending—or, if that fails, to raise new revenues—we would face the prospect of deficits rising to unprecedented amounts, whether measured in dollars, in relation to the GNP, or as a proportion of our limited savings and the supply of loanable funds. We can debate among ourselves just what level of deficit is tolerable in coming years and what is not. We can be tempted to sit back and let a year pass as we discuss what programs should be cut or where revenues can be raised. But I think we all know that, without action, we would be on a collision course between our need for new plant, equipment and housing and our capacity to save—and it would be more difficult to reconcile the requirements for a sound dollar with our desire to grow.

It could be argued we have a little time. A large deficit in the midst of recession should be manageable; it indeed provides some support for the economy in a time of stress. There are also large potential sources of demand in the private economy. The latest economic indicators are not so weak as they were. We can see we are making some progress against inflation, perhaps as fast as could reasonably have been anticipated. In all these circumstances, a degree of patience is needed—and justified.

But delay is another matter. In my judgment, the more progress we can see in restraining costs, and the more resolute your budgetary action, the earlier we can be assured a prompt and strong recovery.

The course of action we have set in the Federal Reserve seems to me consistent with that sense of direction and urgency. But no single instrument of policy can, alone, do the job. We look forward to working with you and your colleagues in the weeks and months ahead to meet these challenges constructively.

* * * * * * *

The **Chairman**. We now have a panel of four outstanding economists: Dr. Martin Feldstein, president, National Bureau of Economic Research; Dr. Joseph Pechman, director of economic studies, the Brookings Institution; Dr. Allan Meltzer, John M. Ohlin, professor of political economy and public policy, Carnegie-Mellon University; and Dr. William Fellner, resident scholar, American Enterprise Institute for Public Policy Research.

I'm not certain whether you have had any time to coordinate how you wish to proceed, but we are hopeful that you might summarize the highlights of your written statement which will be made a part of the record. That will give us an opportunity to ask questions based on what Mr. Volcker may have said or what somebody else may have said or what you may have said. And I assume we can start in the order in which I called the names. Marty, if you want to start first, and then Dr. Pechman.

STATEMENT OF DR. MARTIN FELDSTEIN, PRESIDENT, NATIONAL BUREAU OF ECONOMIC RESEARCH, CAMBRIDGE, MASS.

Dr. **Feldstein**. Thank you, Mr. Chairman. I understand that you would like us to summarize in about 5 minutes apiece.

The **Chairman**. If we could do that. And then after each panelist has had a chance to do that, we will open it up for questions.

Dr. **Feldstein**. I think I can summarize the statement in about 6. First of all, just a comment that I think it would be wrong to be too gloomy about the economy at this point. I think there has been remarkable progress in the last year, which in light of the current recession and high interest rates often get overlooked. I think what you did last year in the tax bill in providing incentives for investment and for individual savings will have powerful long run favorable effects. I think the progress on bringing down inflation has really been very dramatic, very impressive. Much more so than most of the skeptics of a tight money policy expected a year or so ago. And that is permeating through all kinds of prices and wages.

The second point that I want to make is that despite this fall in inflation—no matter how measured—interest rates have remained high because of the fear that inflation may turn around and go back up again in a very substantial way in the latter half of the 1980's and beyond. I think the financial markets are worried that the Fed will expand the money supply in order to speed the recovery, and in order to generate more tax revenue. And then in the longer run, I think they are worried that the Fed will expand the money supply to accommodate the deficit.

I don't think you can explain high interest rates by the deficit per se, by the borrowing requirement of the Federal Government even under rather pessimistic assumptions about how much cutting can be done. But it's the fear that that deficit will lead to a change in monetary policy, it wil lead to the kind of expansionary accommodation that we had in the 1960's and 1970's, in particular, that I think is frightening financial markets.

It's important, therefore, to bring down the prospective deficit not only because of the crowding out of private investment, but also in order to turn around these inflationary fears that are adding so much to the interest rates at the current time.

Third, I think it is possible to reduce the deficit more than the administration has predicted both over the next few years, and over the 5 or 6 years that I think it will take to get the budget in balance. In the statement, I suggest a mix of tax changes, defense spending changes, and nondefense changes that will do that. And it will do that without rescinding either the business or the personal tax reductions that were enacted in 1981.

The key, if one is really to have anything like a balanced budget in 5 or 6 years, is to slow the growth of Federal nondefense spending until the share of GNP that goes into nondefense spending has been reduced to about 13 percent. That was the share of GNP that went into nondefense spending in 1970. I don't think that that is an impossible task. I don't think it represents going back to the Dark Ages in terms of social policy or economic policy. It does represent reducing the share of GNP by about 5 percentage points. That means if one is to do that over 5 or 6 years, slowing the real growth, cutting the real growth of nondefense spending by 2 percent a year. A 2-percent reduction a year over 5 or 6 years combined with a much more moderate rate of real growth than the administration has forecast—a 3½ percent rate of real growth—will bring down the share of GNP going to nondefense spending to 13 percent.

What that means in slightly different words is a reduction of the current real level of nondefense spending by about 12 percent, phased in over 5 or 6 years. And that would bring it back to the 1978 real level.

If you don't do that, you cannot balance the budget without substantial increases in personal taxes.

I think to achieve those kinds of reductions in nondefense spending in a fair way and with the least disruption, it is necessary to broaden the range of programs that are being reduced beyond what the administration has suggested. I think the administration, by omitting any reductions for social security and any significant changes to medicare or the disability programs, has essentially put aside 40 percent of nondefense spending. And that made it virtually impossible to achieve the kinds of reduction over the next 4 or 5 years that would be required.

In the formal statement, I make a number of suggestions for making changes in those programs. The one that I will just mention here is in social security where I think the best thing to do in the short run is to change the indexing formula by having what in insurance terms would look like a deductible in the insurance against inflation. The first 2 percent would not be covered by the indexing. And everything in excess of it would be covered by it. But that would mean a 2-percent floor before indexing began so that if we have 7-percent inflation measured by the CPI, social security benefits would rise, but by 5 percent instead of by the 7 percent under current law. Cumulatively, that would amount to very significant reductions in outlays over a period of years.

Let me also say as I do in the formal statement that all of the changes that I would suggest in social security, medicare and disability and in other programs can be achieved in ways that in effect exempt the poor. It is not necessary, for example, to apply that 2-percent floor on benefits to all social security recipients. One could exempt people whose monthly check is below some amount, and still get virtually all the savings. That most of the dollars don't go to the very poor in these broad programs. And, therefore, we could make changes in medicare and social security which saves tens of billions of dollars without affecting the poor.

Turning to the revenue side, I think it is important not to undo the major changes that were made last year. And I don't think it is necessary to undo them in order to get substantially more revenue than the administration indicated. The decontrol of natural gas, combined with an appropriate windfall tax, perhaps coupled with a tax on imported oil could be an important source of revenue. I've also provided a list of specific changes in tax rules that I think would be desirable even if the goal were now not to raise more revenue.

But turning to the broad personal tax cuts, my view is that one should not rescind that 23-percent tax cut. As you know, that cut is really just enough to offset bracket creep and to prevent the share of incomes that are paid in personal taxes from rising between 1981 and 1984. Even more important, I would urge you not to rescind the indexing that is scheduled to begin in 1985. I think if you did that, it would have a terrible effect on inflation expectations. We all know that without indexing, inflation is a way of balancing the budget; is a way of bringing in more revenue. Without indexing, the temptation to inflate away the deficit is overwhelming. I think if you were to repeal indexing at this time you would give financial markets a signal that inflation is going to have a bigger payoff in terms of tax revenue and be more likely in the coming years.

I will stop there.

[The prepared statement follows:]

On Balancing the Federal Budget

Martin Feldstein

The combination of the current recession, the high interest rates and the recent budget forecasts make it easy to be too gloomy these days. It is important therefore to remember just how much progress has been made in the past year.

The most tangible achievement has been the substantial reduction in the rate of inflation. During 1979 and 1980, the consumer price index jumped at more than 12 percent a year and many people began to worry that inflation was out of control. In contrast, the 1981 CPI increase was less than 9 percent. The producer price index showed even greater progress, with the rate of increase declining from 12 percent in 1979 and 1980 to 7 percent in 1981. The rate of increase of average hourly earnings declined gradually over the year; while January's wages were 10 percent higher than a year earlier, December's wages were only 8.1 percent higher. Most economists anticipate that the 1982 inflation rate will show a further substantial decline.

The significant progress in reducing inflation can be credited primarily to the relatively tight monetary policy during most of the past two years. Tight money prevented the 1980 recovery from developing into a full expansion and then caused a further downturn in economic activity in the summer of 1981. The tight money policy also raised the value of the dollar relative to other currencies and thereby helped to prevent price rises for oil and other internationally traded goods.

Nobody likes a recession but it appears to be the unavoidable price that has to be paid for bringing down the rate of inflation. Moreover, the rise in unemployment has brought much greater progress in reducing inflation than the skeptics of a tight money policy had anticipated. And now that the upward momentum of inflation has been reversed, further gains in reducing inflation should be possible with less slack in the economy.

The financial market is nevertheless still unsure about the decline in inflation and about the Fed's willingness to keep money growth in the coming years within the bounds of gradually declining target ranges. The abnormally high real interest rates at the present time reflect the financial market's fear that the Fed may accelerate money growth in an effort to expand the economy and raise tax receipts or that the Fed may monetize too much of the government debt in future years in an attempt to prevent real interest rates from rising. If the financial market had greater confidence that the Fed would not be persuaded by Congress or the Administration to depart from the policies that Chairman Volcker has announced, the long-term interest rate would be significantly lower.

In addition to the progress in reducing inflation, the major economic achievement of 1981 was the enactment of new tax rules to encourage increased business investment and a higher rate of personal saving. I believe that the accelerated cost recovery rules and the individual retirment accounts will cause a substantial increase in saving and in business investment in the decade of the 1980s relative to their levels in the 1970s. It is important that Congress not change the law in ways that will weaken these incentives. Moreover, priority should be given to the very low cost reform of increasing the $2000 ceiling on IRAs to keep pace with rising incomes.

The principal problem that now clouds the economic future is the series of vast deficits projected in the Administration's recent budget. Even if these budget targets are achieved, the deficits would average nearly $80 billion a year between 1983 and 1986.

But the deficit outlook is even worse because the Administration's revenue forecasts are likely to prove to be overly optimistic. Their forecasts assume a rate of nominal GNP growth that is not consistent with the Fed's plan for limiting the growth of the money stock. If tight money keeps nominal GNP growth below the Administration's projection by one percent a year, personal tax revenue in 1984 will be $20 billion lower and the deficit will exceed $100 billion. And even this bleak figure assumes that the Administration is successful in achieving all of its requested spending cuts.

Sustained deficits of this magnitude are a serious burden for the economy and result in reduced investment, increased inflation or both. Since a government deficit means increased government borrowing from the public, its automatic effect is to raise the real rate of interest and thereby reduce private borrowing and investment. And if the Fed tries to prevent this by purchasing some of the additional government debt, the resulting increase in the money supply would raise the rate of inflation.

While a consistent monetary policy can prevent such inflation, the result would be a substantial crowding out of private investment. Net private investment in the United States is now only about six percent of GNP. A $100 billion deficit in 1984 would imply that the government must borrow two and a half percent of GNP. Since the resulting higher real interest rates would induce an inflow of foreign capital, the government borrowing would not displace an equal amount of private investment. Nevertheless, the impact of a $100 billion deficit on private capital formation is likely to be very significant.

The large deficits are, however, unlikely to cause the financial chaos and extremely high interest rates that some dour Wall Streeters are predicting. Much of that pessimism reflects a confusion between nominal market interest rates and inflation-adjusted real interest rates. The principal reason for high market interest rates is the fear of inflation. If the Fed follows a policy of consistent monetary control, the inflation premium should fall even though there are larger deficits. The direct effect of the deficit is to raise the real interest rate to a level that reduces private spending here and abroad by enough to finance the government borrowing. Since the inflation premium may fall at the same time that the real rate of interest is rising, there is no reason why large deficits should produce higher market interest rates in the future.

How much higher would real interest rates have to be in 1984 if the government deficit that year is $100 billion instead of $50 billion? Although economists don't know enough to give a precise estimate, a reasonable answer is "not much, probably not more than one or at most two percentage points." The rise in the interest rate is limited to the extent that funds are attracted from abroad by a higher U.S. real interest rate. The interest rate increase is also small if domestic borrowers believe that the large deficits are only temporary and therefore that their cost of funds can be reduced by postponing their borrowing. With some $450 billion of annual investment in the United States and more than that in the rest of the world, a temporary increase in government borrowing by $50 billion is likely to have only a negligible effect on the real rate of interest.

Another source of exaggerated pessimism is the concern that large deficits will "abort the recovery." It is, of course, true that a larger deficit, by raising the real interest rate, will reduce spending for plant and equipment, new housing and consumer durables. However, a larger deficit also means either more government spending or lower taxes and therefore more consumer spending, thus providing a direct addition to demand that can stimulate and sustain the recovery.

The real problem is that substantial deficits could eliminate a significant portion of net capital formation. This adverse effect on capital formation, which could occur even if the rise in the real interest rate is small, is the important reason to reduce the projected deficits for the next few years and to bring the budget into balance within five or six years. I believe moreover that such a policy can be designed without rescinding the business or personal tax reductions enacted in 1981.

Slower Growth of Spending

The key to balancing the budget is to slow the growth of Federal nondefense spending until these outlays equal the 13 percent share of GNP that they did in 1970. During the past two decades, the automatic growth of tax revenue induced Congress to vote for new programs and for program expansions that would never be enacted today. Although these programs are generally not without some value, there is an increasing belief that their value is not enough to warrant the high marginal tax rates that would be necessary to finance them in the future.

Returning nondefense spending to 1970's 13 percent share of GNP over the next six years would only require a 12 percent decline in the real level of nondefense outlays, back to the real level that prevailed as recently as 1978. The combination of a two percent a year reduction in real nondefense outlays and a 3.5 percent real GNP growth would be sufficient to bring nondefense spending back to 13 percent of GNP in six years.

A two percent annual reduction in real nondefense outlays can be achieved most fairly and with the least disruption by making changes in the full range of government programs. Unfortunately, the Administration has refused to make any significant changes in the Social Security retirement, disability and Medicare programs that currently account for some 40 percent of nondefense spending. As a result, the Administration has been forced to propose many spending cuts that are unlikely to be enacted, thereby further increasing the probable deficit in future years.

It is now up to Congress to broaden the range of spending reductions, not in order to cut spending by more than the Administration proposed but to distribute the spending cuts in a way that is both fairer and more likely to achieve legislative approval. Changing the Social Security indexing rule to raise benefits only for price increases in excess of 2 percent would save nearly $20 billion in 1986, or about one-tenth of the total required spending reduction. Postponing the age at which full retirement benefits are payable and changing the benefit formula for new retirees could also achieve substantial savings without causing painful adjustments for any individual. Returning to an earlier standard of eligibility for disability benefits could save half or more of the current $18 billion outlay. And requiring Medicare patients to pay a modest share of their hospital charges in the same way that patients with private insurance do would not only reduce the $45 billion Medicare outlay but would also help to control the inflation in hospital costs. All of these changes could be done in a way that exempts those who are truly poor without significantly affecting the revenue savings.

What about defense spending? In dollars of constant purchasing power, the United States spent less on defense in 1980 than it did in 1960. As a fraction of GNP, defense spending halved from 10.0 percent of GNP in 1960 to less than five percent in 1980. As an economist I do not know what fraction of GNP whould be spent on defense. That clearly depends on the efforts being made by our enemies and allies as well as on the technological possibilites for translating more spending into greater deterrence.

The Administration originally proposed raising real defense spending at seven percent a year, a rate that would raise the defense share of GNP by one percentage point in four years and that would double real defense spending is a decade. The revised budget calls for nearly nine percent real growth of defense outlays between 1981 and 1985. Without judging whether such an increase is warranted by military conditions, I will only note that returning to seven percent real defense growth would reduce defense outlays by $20 billion in 1985.

Revenue Changes

Turning to the revenue side, there is much that can be done without revoking the personal and business tax cuts or tampering with the 1985 indexing rule. Rapid decontrol of natural gas prices would conserve this important resource and add $15 to $20 billion a year to tax receipts.

There are several revenue producing changes in tax rules that would deserve to be made even if there were not a deficit. High on my list is limiting the exclusion of employer contribution for medical insurance premiums, a rule that is responsible for much of the inflation of health care costs and that now reduces income tax revenue by more than $15 billion and payroll tax revenue by additional billions. Other tax rules that not only reduce revenue but also distort economic incentives are the exclusion of unemployment benefits (with an estimated revenue loss of more than $5 billion) and of workmen's compensation benefits ($3 billion) and the deduction of consumer interest ($6 billion). The combination of natural gas decontrol and efficiency-improving tax changes could easily add $30 billion a year to revenue in 1984 and beyond.

The personal tax cuts of 23 percent are essentially just enough to prevent bracket creep in 1981 through 1984 from raising the share of income paid in taxes. It would be good, however, to stretch out the 10 percent tax cut scheduled for July 1983 into 5 percent cuts in July 1984 and July 1985. That would achieve the same ultimate tax rates but would do so in a way that reduces the deficits in 1983 through 1985 while the spending reductions are being made. The extra revenues would be about $35 billion in fiscal 1984 and nearly $20 billion in fiscal 1985.

Adding it Up

How does it all add up? The 1982 deficit will be about three percent of GNP. The combination of the business and personal tax cuts and a seven percent real annual increase in defense spending would raise this to about six percent of GNP in 1987. Reducing nondefense outlays from 18 percent of GNP in 1982 to 13 percent would lower the deficit to about one percent of GNP. The changes in tax rules can produce a budget that is predicted to be in balance and that has a good safety margin for keeping the deficit within one percent of GNP.

Two things about this strategy are obvious. First, it will take five or six years to achieve a balanced budget. Although stretching out the personal tax cut can reduce the extent of the budget deficits along the way, there is no way to reduce government outlays rapidly enough to balance the budget by 1984 or 1985. Second, the strategy for balancing the budget without raising taxes can only work if Congress is prepared to make a 10 to 12 percent reduction in real nondefense outlays over the next five or six years. If such spending cuts will not be made, there is no choice but to raise personal taxes. But if Congress is prepared to slow the growth of government spending in this way for the next half dozen years, the basic program of tax reductions, increased investment and lower inflation can succeed.

The CHAIRMAN. Dr. Pechman.

STATEMENT OF DR. JOSEPH PECHMAN, DIRECTOR OF ECONOMIC STUDIES, THE BROOKINGS INSTITUTION, WASHINGTON, D.C.

Dr. PECHMAN. Thank you, Mr. Chairman. I don't have to repeat the obvious point that the budget that the administration has submitted would even, if enacted, yield deficits that are unsatisfactorily high. And I guess the practical problem before us is how do we get the deficits down.

Let me say that I have tried to price out the Reagan budget realistically. I think some of the numbers that are being bandied about underestimate what is likely to happen even if the Reagan budget is approved lock, stock and barrel. As you know, in fiscal year 1985, the budget deficit gets down to about $72 billion. But his assumptions are that we will grow in the next 5 years in the face of high interest rates and high deficits almost as fast as we grew in the early sixties when there was virtually no inflation and when interest rates were 3 percent. These economic assumptions are quite unrealistic. But you don't have to moderate them very much to generate a large increase in the deficit.

For example, if you take the Congressional Budget Office assumptions, which reduce the rate of real growth in the President's budget by about a point and a half—and I think that is not unrealistic—but still provides for quite a handsome expansion, and assuming that the inflation rate goes up by a corresponding amount, the deficit increases by close to $50 billion by that one change alone.

Then I think there are excessively generous estimates in the budget on what they call management initiatives, which means sales of assets and land, accelerated leasing of outer continental shelf lands, and so on. There is also a vast underestimate of the cost of the farm price support program in the budget. If you make realistic estimates for those items, you add another $20 billion to the budget deficit.

Then, the fact that we are going to have a higher budget deficit during the next 3 or 4 years, and probably somewhat higher interest rates, you have to add $20 billion for interest.

Instead of a $72 billion deficit, you are up to a $160 billion deficit in 1985. I think that practically any economist that you talk to would agree that that is outrageous in light of the assumptions that are behind these estimates. It would mean that with unemployment less than 7 percent and the economy growing at a rapid rate, the deficit would amount to between 3½ and 4 percent of the GNP, which would be unprecedented, except for periods of deep recession.

Furthermore, at that time, and under those economic assumptions, clearly, the deficit would tend to crowd out private investment, and, therefore, raise interest rates. It would also, by its very nature, reduce national savings.

So you have a big problem. And the problem is not measured by something like $70 billion in 1985, it is measured by something like $160 billion in 1985. The question is what to do about it.

In making this estimate, I have assumed that all of the Reagan cuts in the nondefense budget are adopted. You have to add to the deficit if the Congress does not adopt every dime of the cuts. My own preference would be to reduce the rate of growth of defense spending and apply some of that to moderate the cuts in nondefense spending.

However, assuming that you do make the savings that the budget proposes, you still have enormous problems that can be resolved only by working on the receipts side. I outline in my paper a number of methods of increasing receipts enough to reduce the $160 billion deficit in half. That would mean $80 billion in 1985 and would cut the deficit to a little less than 2 percent of the GNP. And, hopefully, the deficit would be going down from then on so it would probably be tolerable, assuming, of course, there would be continued pressure on the downside of the deficit beyond 1985.

I suggest a number of steps. First, I think that we simply cannot afford the tax cuts that are now in place for 1983 and the indexation that would begin in 1985. I agree with Martin Feldstein that these ought to be delayed. My own view is that indexation was a fiscal blunder, and that you will probably not enact it in this decade after you look at the numbers.

But be that as you may, even if you temporarily delay on indexation until you can afford it, you would be increasing receipts in fiscal year 1985 by over $50 billion.

I would also deregulate natural gas and adopt a windfall profit tax. That, according to the Congressional Budget Office, would add $12 billion to receipts. To followup on Senator Bradley's questions about tax expenditures, there are many more tax expenditures in the law that are counterproductive. In other words, they do more harm than good. They misallocate resources, and reduce the rate of growth of productivity rather than increase it.

The administration, itself, recommends a menu of something like $20 billion—including withholding on interest and dividends, which you know I have supported it for 30 years. I hope you adopt it.

But I think that my administration has only touched the tip of the iceberg. I have a list in table 1 of my testimony which would, increase receipts by close to $60 billion, $57.5 billion in 1984, and $65 billion in 1985. If you did that—but I doubt that you will do all of it—I think the economy would be better off.

The program I recommend is to defer the tax cuts in 1983 and indexation, deregulate natural gas, and adopt a windfall profit tax, add at least $15 billion from the list of $260 billion of tax expenditures that Senator Bradley suggested. That gives $80 billion. I think it would be a good start on reducing what is an intolerable prospect for the deficit.

Thank you very much.

[The prepared statement follows:]

WHAT TO DO ABOUT THE DEFICIT

by

Joseph A. Pechman

Statement before the Senate Finance Committee

February 24, 1982

I am pleased to have this opportunity to discuss with this committee some of the difficult issues in current budget and tax policies. In this statement, I will discuss briefly the economic and budget outlook, and then turn to methods of reducing the large deficits that seem to be in store for us.

The Economic and Budget Outlook

The Reagan team disregarded budget deficits in making its plans for the next several years. Hence they were able to persuade themselves that taxes could be cut by more than expenditures, without serious economic consequences. But they forgot that the tight monetary policy -- which they support -- would collide with their loose fiscal policy (i.e., continued high deficits). The result has been high interest rates, which brought on the current recession and will continue to retard the growth of the economy.

Assuming there is no incomes policy to reduce the rate of growth of wages and prices directly, the only mechanism that remains to combat inflation is to restrain the growth of money and credit, which then slows down the economy. If this policy is maintained for a long enough period of time, wages and prices will respond. But, as the current experience amply demonstrates, the cost of this policy is very, very high in terms of lost output and unemployment.

Federal deficits exceeding $100 billion a year are now in prospect for the foreseeable future. My own estimate is that the deficits will amount to $110 billion in fiscal 1982, $125 billion in 1983, $140 billion in 1984, and $160 billion in 1985, even if the Reagan budget proposals are fully implemented and the economy grows at the rate projected by the Congressional Budget Office. The 1982 deficit is tolerable because it is a year of recession. However, the deficits in the later years are not tolerable -- unless Congress does something about them, the deficits will raise interest rates and condemn the economy to frequent recessions and slow growth.

I believe that reduction and eventual elimination of the deficits would help to ease interest rates, moderate the effect of monetary policy on the economy, and promote stable growth. In addition, elimination of the deficits (which is really dissaving by the federal government) would increase saving and thus permit a larger increase in investment, which may help to stimulate productivity growth.

Closing the Expenditure-Revenue Gap

The administration and the Congress have already reduced non-defense outlays substantially, and I have little doubt that further cuts will be made this year. My own personal view is that a cut of 5 percent in defense spending for 1985, which would reduce outlays by $15 billion in that year, would not endanger our national security. It would also permit moderation of some of the non-defense spending cuts proposed in the Reagan budget. But even if any savings that can be made in defense outlays are not used for this purpose, there is still a huge gap between expenditures and receipts and that gap can be closed only by action on the tax side.

The source of the problem is that the 1981 tax reductions reduced the revenue potential of the federal tax system in 1983-85 by more than we can afford. In addition, the indexation of the individual income tax which was incorporated in the law effective in 1985 was a major fiscal blunder. It will reduce federal receipts by $12 billion in fiscal 1985, $36 billion in 1986, $51 billion in 1987, and so on.

There are several methods of increasing taxes, some better than others:

1. A traditional method would be to increase excise taxes on tobacco, alcohol, and gasoline. An increase in the tobacco and alcohol taxes, which have not been raised for many years and have been eroded by inflation, may be justified on grounds that the consumers of these products impose costs on society which should be recouped through taxation. A substantial increase in the gasoline tax would be appropriate to promote conservation. However, except for the gasoline tax, the revenue potential of excise taxes is not great: even if all the major excises were doubled, the revenue increase would be about $10

billion in fiscal 1984, and $11 billion in fiscal 1985. Moreover, tobacco and alcohol taxes are generally regressive and increases in these taxes are resisted by the public. If excise taxes are increased, tax increases should also be imposed at the higher income classes to offset the regressive effect of the excises.

2. As natural gas is deregulated, a windfall profits tax similar to the tax now levied on production of oil would be appropriate. Such a tax would not raise as much revenue as was once thought; the Congressional Budget Office estimates that the revenue gain from increased income taxes and a windfall profits tax as natural gas is deregulated would amount to about $12 billion in fiscal 1984. President Reagan opposes the windfall profits tax, but he might reconsider after reviewing the alternatives.

3. Another possibility is to enact a value added tax. This tax is highly inequitable as compared to an income tax, since it is regressive or, at best, proportional. The experience of politicians with the value added tax is not good, but some may turn to this tax if the revenue situation becomes desperate. I hope that Congress will avoid this alternative. The enactment of a value added tax after the large income tax reductions made last year would be a clear indication that the real purpose of recent tax policy has been to reduce the progressivity of the tax system.

4. The best way to increase revenues in the future is to eliminate many of the irrational, uneconomic, and inequitable tax expenditures. The administration recommends several revisions that would raise about $11 billion in 1983 and more than $16 billion in 1984 and 1985. I think that the goal should be to raise at least $50 billion by this means. A list that would easily raise this amount in 1984 and 1985 is given in Table 1. This approach would raise urgently needed revenues and improve horizontal and vertical equity at the same time.

5. Since the huge 1981 tax cuts are major causes of the deficits now in prospect, it would be appropriate to delay or repeal the July 1983 cuts and the indexation that goes into effect in 1985. This would increase revenues by about $37 billion in fiscal 1984, $54 billion in 1985, $76 billion in 1986, and $102 billion in 1987, and would be timed fairly well from the standpoint of countercyclical policy. It would also be useful to accelerate the July 1982 tax cut by three months. The reduction in revenues of $7 billion would help to accelerate recovery from the present recession.

Over the longer run, it will be necessary to review the structure of the income tax to see whether it can be improved sufficiently to remain the major source of revenue for the federal government. I believe that, by eliminating unnecessary deductions, exclusions and tax credits, it would be possible to make the tax much simpler and more equitable than it is today and cut the tax rates well below the rates now scheduled to take effect in 1984.

In summary, we are in desperate fiscal shape as a result of last year's tax-cutting spree and only tough action to increase revenues will remedy the situation. A practical program would be to delay the 1983 tax cut and indexation, deregulate natural gas and impose a windfall profits tax, and eliminate at least $15 billion of tax expenditures over and above the list proposed by the administration. These steps would raise receipts by over $80 billion in 1985 and would assure the capital markets that Congress will not tolerate $160 billion deficits or more when the economy is expecting to be operating at a high level.

Table 1. Revenue Effects of Various Tax Revision Measures, Fiscal Years 1984-85

Billions of dollars

Item	1984	1985
Administration proposals		
Revised contract accounting	5.0	3.2
Remove business energy tax credits	0.4	0.6
Limit tax-exempt revenue bonds	0.3	1.1
Eliminate modified coinsurance	2.2	2.5
Amortize construction period interest and tax	1.1	1.0
Enact corporate minimum tax	4.6	5.1
Speed up corporate tax payments	1.7	0.9
Withhold on interest and dividends	1.3	1.4
Subtotal	16.6	15.8
Additional proposals		
Eliminate 1981 act saving provisions	2.0	5.6
Eliminate tax-exemption for all industrial development bonds	3.6	3.7
Eliminate deferral of income by domestic international sales corporationss (OISC)	2.0	2.0
Repeal percentage depletion	1.6	1.9
Terminate deductibility of consumer interest payments	7.8	8.1
Limit home mortgage interest deductions to $5,000	1.0	1.3
Terminate deductibility of state and local sales taxes	5.3	6.0
Tax one-half of social security benefits	9.6	11.3
Tax all unemployment insurance benefits	1.7	1.7
Limit tax-free employer contributions to health plans to $120 a month	3.3	4.4
Raise the threshhold for medical expense deduction to 10 percent and eliminate separate deduction for health insurance premiums	3.0	3.2
Subtotal	40.9	49.2
Total revenue effect	57.5	65.0

Source: Budget of the United States Government, Fiscal Year 1983, pp. 3-12, 3-15, and 4-9; and Congressional Budget Office, Tax Expenditures: Current Issues and Five-Year Budget Projections for Fiscal Years 1982-86 (September 1981).

The **Chairman**. Dr. Meltzer.

STATEMENT OF DR. ALLAN MELTZER, JOHN M. OLIN PROFESSOR OF POLITICAL ECONOMY AND PUBLIC POLICY, CARNEGIE-MELLON UNIVERSITY, PITTSBURGH, PA.

Dr. **Meltzer**. Thank you, Mr. Chairman. In my statement, I stress the uncertainty about Federal Reserve policy and budget policy. I like to think about the problem of the budget by telling a very brief story, a good news, bad news story. The good news is that a busload of supply siders fell into a ravine. The bad news is that there were three empty seats. [Laughter.]

Dr. **Meltzer**. I support the general program of monetary deceleration, deceleration in the growth of Government spending, reductions in tax rates, and deregulation, which has been emphasized by this administration. I strongly disagree with Mr. Pechman's program. He would solve our budget problems by raising taxes and repealing indexing. The latter raises taxes by using inflation to put people into higher tax brackets.

The problem with the administration's program is not its general thrust; it lies with its implementation. I enjoy hearing Mr. Volcker speak. I enjoy reading his statements. I agree with most of what he says but with little of what he does. If you look at table 1 of my paper you will see that while he has been making clear and definite statements about the need and the desirability of slow money growth, for the last 6 years, neither he nor previous Federal Reserve chairmen have remained within their target bands. Four out of the 6 years they have been outside, the entire target band. No matter how large they made that target band, 4 out of the 6 years, they were not able to get in the band. And Mr. Volcker's experience with controlling the money stock in the last 2 years has not been any better. Indeed, even worse. Not only is money growth highly uncertain, it is highly volatile. Is it any wonder, therefore, that people in the financial markets have no idea as to whether interest rates are going to be high or low or whether money growth is going to be large or small, whether the bands are going to be met? Is it any wonder that there is uncertainty in the financial markets?

If you look at the rates of interest, adjusted for inflation, in the United States and other countries, then you get an estimate that the risk premium in the United States is extremely high. And that risk premium is there not only because the Fed doesn't meet its target, but because one cannot be certain from the experience of any 3-month period what the growth rate of the money stock will be in the next 3-month period or for the year.

That situation requires correction. It can be corrected and should be corrected. Since the Federal Reserve is a creature of the Congress, I believe it is something that the Congress should do. The Congress treats the Federal Reserve with care; the chairman states desirable goals that we all share. But the implementation of his policies leaves much to be desired. Something needs to be done.

We had the experience of 1980. The growth of the money stock collapsed for part of the year, and then soared. Is that going to be the experience of 1981-82? We had a big drop. Will there now be a big rise? What will the growth rate be at the end of the year?

We've had at an annual rate—even if there were no further growth from the money stock for the rest of this quarter, we would have 10-percent rate of growth for the quarter. That translates into something in the neighborhood of 2½ percent for the year. We are at the lower edge of the annual band, if we have no money growth from here on. Is Mr. Volcker, then, going to remain in his target band? How is the market to decide that? Or since 1982 is an election year, are we going to see a return to the 1980 experience. Will we now get a correction for what happened for the last 3 months? And then another surge because the Federal Reserve reluctant to raise interest rates in an election year. Who can be certain about those decisions? How can consumers, businessmen, investors, speculators, bond people, stock market people, or anyone else make long-term judgments in the face of pervasive uncertainty? We need to do something to correct that uncertainty. It isn't just the tenor of what the chairman says, it is the character of what he does that is important.

Let me turn briefly to the fiscal side. Monetary policy is not our only problem. The budget problem—there is great uncertainty about the budget problem and how it will be resolved. We are, I believe, on the verge of a fiscal crisis. Not in 1982 and 1983, the years which receive so much attention. There seems to be an internal inconsistency or at least a question about the internal consistency between the projections for the economy and the projections for the budget deficit. We have never had an experience anywhere in the world like this. The largest economy in the world has a rising share of saving used to finance the deficit. As we look out not just to 1984, but on out as far as we can project, we do not see the size of the budget deficits coming down relative to GNP or saving. That's a problem which I think hangs over the economy and creates uncertainty about how the problem is going to be resolved. Coupled with the uncertainty produced by monetary policy, we have very uncertain outcomes.

I believe the policy of the administration is correct. The implementation leaves much to be desired. We don't know whether the deficit as a share of income or as a share of savings will continue to rise as any reasonable set of projections could easily show them doing. No one can be certain. We need to do something. We must make further cuts in the growth of spending, implemented in 1982 for the 1983 budget. The cuts should not be concentrated on the deficits in 1982 and 1983, but concentrated on making cuts which will show a declining path of deficits as a share of income in 1984, 1985, 1986, 1987, and 1988, under reasonable assumptions; not under a best case scenario such as has been provided by CBO.

CBO gives a best case scenario. There are no recessions. There is a stable growth of 3½ percent. And in order to bring the deficit down—if one wants to call it a best case scenario—there is a very slow decline in the rate of inflation. Much less than we ought to settle for in the monetary program.

How should this problem be resolved? I don't think it's just a matter of political decision. Real income after taxes, real wages after taxes, have been growing very slowly or falling for years. Despite the noise which one sees in the press and the clamor that comes from various people who have spoken on the issue, real transfer payments have not been reduced. Real transfer payments have been rising. And so we must make a correction. You have voted in transfer programs based upon assumptions about the economy growing and prospering at a rate which we have not achieved. Now that we know that we are poorer, partly because of oil, partly because of low productivity growth or for whatever reason, we have to make a recontract. You have to reduce some of the transfers you have given away because your decisions were based upon a belief that turned out to be false. It is time now to make those adjustments by reducing the growth rate of spending, not by pushing consumers and businesses into higher tax brackets.

I would like to conclude by reading the last two paragraphs of my statement which say what I think is the central issue.

Current fiscal and monetary problems pose a challenge to representative government. The problems are easy to state. Solutions are not hard to find. There are many. None are easy to implement. None are costless. None can be chosen on technical grounds alone. The problem is political; we must change our policies and the implementation of our policies.

At issue is the ability of representative government to put an end to the current fiscal crisis and the rising instability brought about by destabilizing budget policies and Federal Reserve actions. The alternatives to a change are much less attractive. We run the risk of sliding into the combination of immobilism and instability characteristic of modern Italy or of moving to some other less desirable solution that no one can now foresee.

Thank you.

[The prepared statement follows:]

An Uncertain Outcome

Brief Statement prepared for the
Senate Finance Committee
Wednesday, February 24, 1982

by Allan H. Meltzer

The administration's budget policy and Federal Reserve monetary policy have at least one common feature. Both increase uncertainty about the future and thereby make planning for the future difficult. The reasons are very different, however.

Federal Reserve Policy

The main problems with Federal Reserve policy arise because, despite statements full of good intentions and worthy goals, the Federal Reserve does not make any of the changes that would improve monetary control and lower interest rates. No one can have any confidence in Federal Reserve statements that reaffirm their commitment to slower money growth and lower inflation because, more often than not, the Federal Reserve has not honored previous commitments. Currently, as in the recent past, a wide gulf separates Federal Reserve statements and Federal Reserve actions. Table 2 shows the discrepancy between Federal Reserve announcements and achievements for the six years in which they have announced targets for money growth.

Table 1

Money Growth 1975-81

Year Ending in 4th Quarter	Percent Growth		Actual	Error
	Target Announced by Federal Reserve	Target Mid-point		
1976 (M-1)	4.5 - 7.5%	6.0%	5.8%	-0.2%
1977 (M-1)	4.5 - 6.5	5.5	7.9	2.4
1978 (M-1)	4.0 - 6.5	5.2	7.2	1.9
1979 (M-1)	3.0 - 6.0	4.5	5.5	1.0
1980 (M-1B)	4.0 - 6.5	5.2	7.3	2.0
1981 (M-1B)	6.0 - 8.5	7.2	5.0	-2.2
1982 (M-1)	2.5 - 5.5	4.0		

In four of the most recent six years, the Federal Reserve failed to keep money growth within the pre-announced target band. Since 1979, the Federal Reserve claims to be more concerned about money growth, and gives greater emphasis to money growth in its statements, but monetary control has worsened. Annual errors are larger, and short-term variability has increased. Better procedures, endorsed by virtually all monetary economists, including Federal Reserve staff, are available, but they have not been adopted.

Recent Federal Reserve policy is more variable than in preceding years. Sudden shifts in policy have been a principal cause of two recessions experienced in the last two years. The surge in money growth during December and January will, if continued, reverse the progress made toward lower inflation. An attempt by the Federal Reserve to remain within the announced target band for the year will require slow growth for the rest of 1982 and produce a pattern roughly similar to the 1981 pattern. It seems likely that the Federal Reserve will neither maintain the high rate of increase of the most recent quarter nor return to its announced growth path.

What will the Federal Reserve do in 1982? Neither you, nor I, know. They do not seem to know. Why should anyone expect homebuilders, farmers, investors or consumers to act boldly or confidently in the face of this pervasive uncertainty about money growth, inflation, interest rates and the prospects for sustained recovery that is, in part, a result of Federal Reserve policy? How can anyone be confident that interest rates will rise or fall under current conditions? Is there any reason to wonder why published forecasts of interest rates now cover the widest spectrum in memory?

These questions reflect the uncertainty we all experience. The response of the Congress to the uncertainty is puzzling. The Federal Reserve is a creature of the Congress, but the Congress does not undertake to improve the Federal Reserve's performance despite repeated failures to meet its targets. We are in danger of losing this current opportunity to have less inflationary, more stabilizing policies.

Budget Policy

The administration's budgets for fiscal 1983 and future years, when combined with currently available guesses or estimates about future economic activity and inflation, raise doubts about the internal consistency of the fiscal program and the future stability of the economy. These doubts are of two kinds. One concerns the success of the promising effort to restore productivity growth to its historic path and increase personal incentives by reducing current and future tax rates. The other is the increased probability that the budget deficit will rise at a faster rate than output, thereby reducing real capital formation and generating increasing economic instability with rising real rates of interest, falling productivity and a chain of events that no one can forsee accurately or predict reliably. There is no way to anticipate the full effect of ever-increasing real budget deficits and an ever-increasing share of total saving absorbed by deficit finance. While no one can be confident about the effects of continuously increasing deficits, the effects are unlikely to include any of the paths of stable growth and declining inflation used by CBO, OMB and private forecasters to generate budget data for the next five fiscal years. There is, therefore likely to be an inconsistency between the projections for the economy and for future deficits. The result may be deficits larger than forecast, a decline in real income and standards of living leading to an economic crisis. Or, the economy may continue to limp along the path characterized by low productivity growth, rising real transfer payments and a rising size of government.

There is nothing certain about these outcomes, or any other. We have no prior experience on which to base a reliable judgment because there is no example in which a large economy – the largest economy – ran deficits of this relative magnitude for an indefinite period. There is great uncertainty. Prudence requires that the uncertainty be lessened, promptly.

I want to expand my views on three aspects of the budget problem. These are the degree to which the problem is now manageable, the extent to which the underlying policy program is correct, and the type of action that should be taken to reduce future deficits.

First, I believe the budget problem is manageable. I am less concerned about the deficits for fiscal years 1982 and 1983, that receive so much attention, and more concerned about the stream of deficits that continue – and seem likely to rise relative to our ability to produce output – for the forseeable future and beyond. The near-term deficits raise serious problems for housing and for the merchandise trade balance, but these problems are manageable; the longer-term deficits may not be.

Second, I continue to believe that the administration's policy or program is correct. Reducing the growth of government spending, reducing the share of output spent by government and reducing tax rates is a means of increasing incentives to save, work and invest. The problem is not in the policy conception or design but in its implementation. The proposed reductions in spending are too small relative to the projected reductions in tax collections. To achieve the promised gains from tax reduction requires additional cuts in the growth of spending. The principal reason is that current policy does not reduce the share of output spent by government and may, instead, lead to increases in that share.

While the share of output spent by government is a more reliable measure of applicable tax rates than the revenue share, no single measure summarizes the incentive and disincentive effects of government programs. Nevertheless, when the administration proposed the fiscal reform program, and when the Congress adopted Humphrey - Hawkins and the 1981 fiscal program they proposed to reduce the share of output spent by government to 20% of GNP or less. This promise is unfulfilled and is unlikely to be fulfilled. Currently, government spending remains between 23% and 24% of output, and the percentage is not likely to be reduced without further reductions in the growth of spending.

Third, for the United States, at present there are two main ways to use fiscal policy as a tool to increase productivity growth – by increasing the share of output invested in capital and other productive assets – while reducing the deficit. We can, as a nation, decide to reduce the growth of consumer spending, relative to GNP, by raising tax rates on consumer spending. Or, we can reduce the growth of government spending, relative to GNP.

Taxes on spending encourage consumers to save more and spend less. The additional saving finances investment, and the additional taxes reduce the deficit. Raising taxes on consumers forces the current generation of consumers to finance capital accumulation and maintains the size of government.

Reducing the growth of government spending lowers the budget deficit relative to GNP and allows consumer spending to rise. Major reductions in projected spending are difficult to implement quickly. Fortunately, the budget problem does not require substantial reductions in the outlays for fiscal 1982 and 1983. But, action is required this year to reduce spending for fiscal years 1984 and beyond. This is particularly true of military spending, where the distinction between obligational authority and outlays is most relevant, but the distinction is not limited to military spending.

I believe that the better solution is to reduce the growth of spending, not to raise taxes. The main reason is that two oil shocks, inflation and slow productivity growth have left us poorer than we expected to be when many of the income maintenance and transfer programs were adopted or expanded in the past two decades. Consumers' real incomes, after taxes, reflect the slower growth of real income. Most transfer payments do not. Transfer payments have increased in real terms at a faster rate than real income, consumer spending and real wages.

Concluding Comments

Current fiscal and monetary problems pose a challenge to representative government. The problems are easy to state. Solutions are not hard to find. None are easy to implement. None are costless. None can be chosen on technical grounds alone. The problem is political; we must change our policies.

At issue is the ability of representative government to put an end to the current fiscal crisis and the rising instability brought about by destabilizing budget policies and Federal Reserve actions. The alternatives to a change in policy are less attractive. We run the risk of sliding into the combination of immobilism and instability characteristic of modern Italy or of moving to some other less desirable solution that no one can now forsee.

Allan H. Meltzer - Supplementary Statement

Additional Statement on Tax Increases

The prospective budget deficits can be closed either by reductions in expenditures or by increases in taxes. I favor the former, for the reasons given in my statement.

If taxes are to be raised, I favor a tax on imported oil of $5 per barrel or more. Initially a tax on imported oil would raise domestic oil prices to the level of imports and increases revenues from the windfall profits tax. A ballpark estimate of the increase in revenues is, approximately, $20 billion if the tax is effective through the full fiscal year 1983.

An important, additional reason for favoring this tax is that it will encourage substitution of domestic for foreign oil in consumption. The current position of the world oil market places considerable downward pressure on the prices charged by the OPEC cartel. A further reduction in U.S. imports would, I believe, be followed by additional price cutting. Reductions of this kind, if achieved, would be of benefit to all other market economies that are not importers of oil. The world would pay a lower price for oil. If this occurred, prices by U.S. consumers would not rise by the full amount of the tax.

The current position of the oil market, and the current and prospective balance of payments position of most OPEC members offer an attractive opportunity to reduce the world price of oil for a sustained period. The lasting benefits to Western Europe, Japan and to our military-political position add to the usefulness as a revenue producing measure.

The **Chairman**. Dr. Fellner.

STATEMENT OF DR. WILLIAM FELLNER, RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH, WASHINGTON, D.C.

Dr. **Fellner**. Mr. Chairman, I would like to summarize very briefly some parts of this paper that I prepared but which contains numbers I wouldn't know how to present without looking at this in detail.

The **Chairman**. Your full statement will be made a part of the record, Doctor.

Dr. **Fellner**. Well, I will do what I can to say it without any numbers in front of you. I am one of the people who are very sympathetic to the main thrust of the administration's program, which is to disinflate the economy, and to remove some of the disincentives which are in our tax structure and in other characteristics of our institutional setting. That is to disinflate and create supply stimuli.

I think what needs to be avoided in order to establish credibility of this program and to create confidence in the markets is to avoid certain ambiguities which are in the official pronouncements, including the budget documents, which makes everybody wonder which of two routes will be chosen if ambiguities force a choice between two routes.

Now I will use two illustrations for this. One of them is the nominal GNP projection in the budget. This nominal GNP projection in the budget foresees for the coming few years an average rate of increase of about 10 percent in nominal GNP. That is not compatible with gradually eliminating inflation. The past periods in which we had this kind of an increase in nominal GNP were always significantly inflationary. As a matter of fact, these were periods of rising rather than declining inflation. And the budget document does have this projection.

Now the Federal Reserve targets are not compatible with this in all probability. They could be compatible only if money velocity rose very much more steeply than has been the case in the past. What will happen if an inconsistency develops? If an inconsistency develops, which way will it be resolved? This must leave the markets in great uncertainty. If the Fed accommodates a 10-percent increase in nominal GNP over the next few years, that will not fit into a disinflationary program. If velocity should rise to the extent to which it would have to rise to make the Fed money growth targets compatible with that, then the money growth targets should be adjusted. And it is unlikely that velocity will rise at that rate. So here you have an ambiguity. The markets don't know which way you will go then. And that creates a great deal of uncertainty. And even if the right decision will be made, this slows readjustment of expectations to the disinflationary program. That is one remark I wanted to make.

The other relates to deficits. Obviously, a careful analysis of what deficits mean to the economy would require going into details and fine points which I will not do. I will concentrate on one proportion, namely, the proportion of private savings that are absorbed by the Federal deficit. If you want to arrive at finer conclusions from that, a number of qualifications would have to be added, but I don't think they would change the conclusions significantly at all.

Now let me look at these numbers here and perhaps read that one paragraph before I finish. That is on page 3.

The simple relationship in question is that of the Federal deficit to the aggregate savings of the public, that is, the percentage of the public's savings—net personal plus corporate savings—that is absorbed by Federal deficits. In my appraisal, very optimistic assumptions need to be made across the board to arrive at the estimate that in 1984 this percentage will fall short of the two highest percentages observed for any year during the past quarter of a century, provided we compare 1984 with years no less favorably located in the business cycle than 1984 will be in the administration's scenario for the next few years.

I describe the method by which I selected my years in a footnote.

If we consider these 12 years which qualify as no less favorably located than 1984 will be according to the administration's scenario—if we consider these 12 years of the past—we find that the highest percentage of savings was absorbed by the Federal deficit in 1977. This was 40.3 percent. We obtain the next highest proportion for 1978. This was 32.6 percent. Now both these years fall in a period with unusually weak productivity trends. That was really a very disappointing period. It is in these two periods that we find the highest figures for savings absorbed by the deficit, namely, 40.3 and 32.6.

The next highest percentages are in the neighborhood of 20 percent. Two of the 12 years considered were surplus years. On very optimistic assumptions, across the board the data suggest for 1984 close to 27 percent. If this degree of optimism is slightly reduced—if the calculation is made more realistic—the data suggest for 1984 between 30 and 40 percent. And on somewhat more pessimistic or cautious assumptions the data suggest for 1984 a proportion exceeding 40 percent. In this regard we are likely to be heading for proportions just about matching or even exceeding proportions experienced only in the disappointing late seventies.

Now it follows from this that if the proposed deficit reductions are adopted, and if the scenario of the administration comes through, which is an optimistic scenario in a lot of respects, even then we are at very high ranges of historical experience. And if not everything goes very well in those regards, then we are beyond past experience, past historical experience, in how much this deficit will absorb of the available savings even if we make exceedingly favorable savings assumptions. And what I made there is the assumption that we get 8 percent savings relative to the GNP, while at present, we are at 5.3. And that would really be a very high figure.

My conclusion from this is that we should give very serious consideration to raising consumption taxes. I would not go back on the personal income tax program because I would not like to see us return to the marginal tax rates to which we got through the bracket creep, which I think is quite an unconscionable way of managing fiscal affairs.

But I do think we should give serious attention to consumption taxes in addition to adopting the deficit-reducing measures proposed by the administration.

[The prepared statement follows:]

Testimony Before the Finance Committee of the U. S. Senate

Presented on February 24, 1982

by

William Fellner
American Enterprise Institute
Yale University, Emeritus

Mr. Chairman:

I greatly appreciate this opportunity to express my views before the Senate Finance Committee.

May I begin by saying that I belong among those who have for a long time suggested a reorientation of our policies toward disinflating demand and also toward reducing the disincentives to supply created by our tax structure and by other features of our institutional setting. These are objectives which the program here under review is intended to serve and which are effectively served by many of the measures recently taken, as well as by many of those proposed for the future.

However, what I think needs to be avoided much more carefully than has been the case so far are official pronouncements involving ambiguities and thereby creating a great deal of uncertainty in the markets as to whether the authorities will persist in their disinflationary and investment-promoting posture. I will use two illustrations: problems raised by the official nominal GNP projections and problems raised by prospective budget deficits.

The roughly 10 percent annual growth rate of nominal GNP projected in the budget for several future years is incompatible with moving gradually to practically noninflationary conditions and thus is incompatible also with the

Federal Reserve's announced intention to move gradually to practically noninflationary rates of increase of the money supply. Periods of such steep increase in nominal GNP -- roughly 10 percent a year -- have so far been significantly inflationary periods; they were periods of rising not of diminishing inflation rates. A successful disinflationary program would require putting us gradually in shape for moving through future business cycles -- not yet the present cycle -- with something like a 5 percent average annual increase of nominal GNP. The path of numerical money-supply targets which the Federal Reserve seems to be planning at present might well be consistent with this conception, but in this case that path would prove inconsistent with the Administration's nominal GNP projection. Indeed, only in the event of an unusually steep sustained increase in money velocity would the path of numerical money-supply targets which the Federal Reserve seems to be planning prove compatible with the Administration's inflationary nominal GNP projection. But if that should be the case, then the Federal Reserve should further lower the path of its numerical money-supply targets.

The road to the right decisions is not closed by such ambiguities but the markets have remained in uncertainty as to which course will be chosen, and this slows the adjustment of market expectations to the desirable policy course even if at the end that should prove to be the chosen course.

Let me now turn to the problem of budget deficits. Quite generally -- aside from the present context -- this is a problem a professionally responsible appraisal of which would have to take account of a good many "fine points". Some finer points might indeed come up in the discussion following the brief statements of my colleagues and myself; yet here I will limit myself to calling attention to a simple relationship that, I suggest, is significant. What I am essentially suggesting (and would be glad to defend) is that the refinements and qualifications are not weighty enough to deprive of its significance the simple relationship to which I would like to call attention.

The simple relationship in question is that of the Federal deficit to the aggregate savings of the public, that is, the relation expressing the percentage of the public's savings -- net personal-plus-corporate savings -- that is absorbed by Federal deficits. In my appraisal, very optimistic assumptions need to be made across the board to arrive at the estimate that in 1984 this percentage will fall short of the two highest percentages observed for any year during the past quarter of a century, provided we compare 1984 with years no less favorably located in the business cycle than 1984 will be in the Administration's scenario for the next few years. Using the method explained in the footnote, I considered twelve such past years.[1] If we consider these twelve years we find that the highest percentage of savings was absorbed by the Federal deficit in 1977; this was 40.3 percent. We obtain the next highest proportion for 1978; this was 32.6 percent. Both these years fall in a period with unusually weak productivity trends. The next highest percentages are in the neighborhood of 20 percent, and two of the twelve years considered were surplus years. On very optimistic assumptions across the board the data suggest for 1984 close to 27 percent; if this degree of optimism is slightly reduced the data suggest for 1984 between 30 and 40 percent; and on somewhat more pessimistic (or cautious?) assumptions the data suggest for 1984 a proportion exceeding 40 percent. In this regard we are likely to be heading for proportions just about matching or even exceeding proportions experienced *only in the disappointing late seventies (1977-78)*.

---

[1] The question of cyclical comparability is a matter of importance because in years unfavorably located in the cycle the diversion of savings from investment to deficit-financing does not have the importance here suggested. For a comparison with 1984 I took, beginning with 1956, all years that were second years of expansion after a year in which a lower turning point occurred and also all years in which cyclical peaks occurred and the years preceding these. Double counting by the two criteria was, of course, avoided.

What are the across-the-board optimistic assumptions leading to the conclusion that close to 27 percent will be the proportion of 1984 savings absorbed by the deficit of that year? That is, what assumptions would make the 1984 proportion come out in the high range by past experience but would nevertheless make it come out lower than the two highest percentages observed for "comparable" years in the seventies (as defined in footnote 1)? The assumptions leading to this conclusion include the assumption that all economic performance projections of the budget documents come out right; *and* that, net personal-plus-corporate savings will by then be 8 percent of the Administration's GNP estimate, as against the 6.6 percent observed for 1977 and the 5.3 percent observed for 1981. Now, if, in addition to the 8 percent saving rate we assume that Congress will enact all the newly proposed deficit-reducing measures, then, with all these assumptions jointly made, the officially projected 1984 Federal deficit would absorb 26.7 percent of the public's net savings.[2] This is less than the 40.3 percent obtained for 1977 and less than the 32.6 percent obtained for 1978, though even the 26.7 percent is quite a bit higher than the analogous percentages obtained for all other "comparable" past years. But what if we reduce the here implied degree of optimism?

If we reduce our across-the-board optimism by assuming a 7 percent instead of an 8 percent personal-plus-corporate savings rate relative to

---

[2] To be precise, this implies a saving ratio of *slightly* more than 8 percent (and the next paragraph *slightly* more than 7 percent) because for 1984 I have no calendar-year deficit estimates and for that year I therefore related the F.Y. deficit to the larger calendar year GNP times 0.08 (or 0.07).

GNP -- or rather assumed that the deviations from the across-the-board optimistic scenario will add up to the equivalent of this change in the savings assumption -- then we would obtain 30.5 percent for the proportion of the 1984 savings absorbed by the Federal deficit, and this proportion is very nearly as high as the second highest proportion of the past (1978); and if we continued to assume the 8 percent saving ratio, but assumed that the deviations from the across-the-board optimistic scenario will be the equivalent of enacting only one-half of the newly proposed deficit reduction, then the proportion of the 1984 savings absorbed by the Federal deficit would be 40.3 percent. This is as high as the highest proportion observed for any past "comparable" year (1977) and is quite out of line with any other of the twelve observations for "comparable" years.

I will not speculate here about further moves away from a very optimistic scenario. Nor will I discuss the refinements and qualifications for which such simple comparisons call but which in my appraisal are much less weighty than is sometimes implied. Instead, I will conclude these remarks by suggesting that options for raising consumption taxes deserve serious consideration.

The **Chairman**. Senator Byrd.

Senator **Byrd**. Senator Bradley has another meeting to attend, so I will let him go first.

Senator **Bradley**. Thank you, Senator Byrd, very much. I would like to ask Dr. Pechman and Dr. Feldstein—in both their testimonies, they alluded to tax expenditures as a possible way that we could go. I wonder what criteria you might advise the committee to apply to the $260 billion in tax expenditures that might guide us as to which ones we might suggest and which ones we should stay away from.

Dr. **Pechman**. Well there are several criteria. One is whether the tax expenditure achieves the objective that it was designed to achieve. I think many of the tax expenditures simply don't do what they were expected to do. The all savers certificate was mentioned earlier and that's a clear-cut case. That, of course, expires at the end of this year, and I hope it will not be renewed.

Senator **Bradley**. Could I just interrupt and say that you are operating in a little different environment this year than we were last year when a lot of these tax expenditures were passed. When the marginal rate was 70 percent, that might have required you to give a tax expenditure to X, Y, and Z to stimulate investment, but since the marginal rate has dropped to 50 percent, the question is which ones should we now consider?

Dr. **Pechman**. Yes. A second point is whether the tax expenditure unnecessarily distorts investment decisions. I think, for example, the preferential treatment given to interest on industrial development bonds permits wealthy people to avoid taxes, and raises interest rates on other tax-exempt securities, as well as on taxable securities.

I would eliminate the DISC provision, which I don't think has done very much good, and costs a lot of money. I would also do some things that would raise the taxes of the middle class and even the lower middle class. For example, it seems to me that the exemption for social security payments was ill advised from the beginning. Even if you assume that half the social security benefits paid for by the employee, which is not the case, there is still another half that is not taxable.

I would also tax that other half. I would tax all of unemployment compensation benefits. We now tax them only if the individual's income is above $15,000; if he is married, he is not taxable until his income reaches $20,000.

I would limit the medical expense deduction to 10 percent. And I would eliminate a separate deduction for health insurance premiums. I would also put a lid on employer contributions to health plans and so on.

All of these things, it seems to me, would improve the allocation of resources and improve the fairness of the tax system. They would also reduce the deficits, which, of course, would reduce inflation over the long run.

My table 1 gives a list of tax expenditures of close to $60 billion in 1984 and 1985. I hope that you look at the table carefully. I am not sanguine about the chances of getting a significant share of it, and that's why in the statement I said I hoped that Congress should add, at a minimum, $15 billion to what the administration recommends.

Senator **Bradley**. Dr. Feldstein.

Dr. **Feldstein**. I think you can't make any general rules. You have to look at each one on its own merits, although highest on the list would be those which are harmful. And I think you mentioned several of those in your statement earlier, and they happen to be similar to the ones that I have already listed here. The health insurance exclusion that employers and employees currently get for health insurance contributions.

Senator **Bradley**. So you are saying you would address both employer and employee?

Dr. **Feldstein**. Yes. I think that the key thing is not to allow individuals to buy health insurance with dollars that otherwise go untaxed. They should buy them with after-tax dollars rather than before-tax dollars. I would agree with Joe that the exclusion of unemployment benefits is one of those things that not only has adverse revenue effects, but, more important, distorts the decision of employees, and even more important of employers. And employees working together in thinking about things like temporary layoffs to misdirect compensation through the unemployment insurance route. The interest deduction for interest paid in excess of investment income—I think is also on the list that I had in my testimony—is one that does harm in undermining the savings incentives that you enacted last year.

On the useless list, I would put the all-savers very high. I think there was very widespread understanding that that wasn't going to do anything to really help encourage savings. There was a mistaken view that it was going to do a lot to help the thrift institutions and the banks. And I think both of those are now clearly false. And that's a good candidate for elimination.

I would add one general caution, and that is that these features of the tax laws are something that people come to expect when they make long-term commitments. And turning off any particular one can only be done when one has thought about the impact on expectations more generally. You want people to rely upon the stability of the Tax Code when they make decisions. And certain kinds of changes would have very severe effects immediately on people's capital positions and on businesses capital positions. If you were to disallow mortgage interest payments, which I know you wouldn't, that would have drastic effects on the net equity that people have in their homes. So I think more generally there is the feeling that you have an obligation to not make an abrupt turnaround in things that people have relied upon in the tax laws.

One final point on this issue. We talk about it as if the only tax is the personal income tax or the corporate tax. And all the tax expenditure numbers that you quote exclude the social security tax. But with something like the employer payments for health insurance, the revenue loss to the social security system is also extremely large from excluding that from employee compensation. And I think if you decide to close some loopholes with the respect to the definition of income, it is important to include that in income for the purpose of social security tax as well as income for the purpose of the personal income tax.

Senator **Bradley**. You mean include social security payments?

Dr. **Feldstein**. No. Take something like employer payments for health insurance benefits. They are now not income.

Senator **Bradley**. Right.

Dr. **Feldstein**. They are not income for the personal income tax, and they are not income for the social security tax.

Senator **Bradley**. I see.

Dr. **Feldstein**. And the temptation would be to say that's income for personal income tax purpose, but it's not payroll income for social security purposes. And there would go $10 billion or more. I am saying make sure that when you decide that something is income, you call it income for both personal income tax and the social security tax.

Senator **Bradley**. Thank you.

The **Chairman**. Senator Byrd.

Senator **Byrd**. Dr. Meltzer, you made a statement which I think is very significant. If I understood you correctly, you said you feel we are on the verge of a financial crisis.

Dr. **Meltzer**. Fiscal crisis.

Senator **Byrd**. Fiscal crisis. How do you differentiate between financial crisis and fiscal crisis?

Dr. **Meltzer**. Well, in my statement I say that the fiscal crisis arise from the fact that projected growth of Government spending relative to GNP doesn't come down. The share of Government spending to GNP does not go down, then the share of taxes to GNP falls. The result is that the deficit increase relative to GNP. What is that going to do to the economy? We don't know whether it will produce slow growth, lagging productivity growth, or whether it will produce an explosion in real interest rates. As I look out to 1986, 1987, 1988, I have no idea. And I don't think anyone else has a clear idea. We have not been in that situation before.

Senator **Byrd**. But we are, you feel, on the verge of a fiscal crisis?

Dr. **Meltzer**. That's right. We seem not able to manage our fiscal affairs. And we do not show any determination to manage our fiscal affairs.

Senator **Byrd**. Well, I agree with you. There are a lot of numbers, of course, floating around and no one can be certain of what the deficit figures will be. But in my judgment, we will have a $100 billion deficit 3 years in a row.

Dr. **Meltzer**. At least.

Senator **Byrd**. That represents a fiscal crisis.

Dr. **Meltzer**. Well, I am much more concerned not just about 3 years—1982, 1983, 1984—but the fact that one sees deficits continuing to rise in 1985, 1986, 1987. That's as far as anyone has formally projected them. But it would be a foolish man who would say that 1987 is the end of the problem. 1988, 1989, 1990, as long as we project out those deficits, we not only don't see them getting smaller, we don't see them getting smaller as a share of income. That's what I mean by a crisis. Our ability to finance those deficits does not seem to be increasing as rapidly as the deficits.

Senator **Byrd**. With a $100 billion deficit for 3 years or more than that, how can we bring interest rates down with such huge deficits such as that?

Dr. **Meltzer**. Well, real rates—that is, rates adjusted for inflation—may fall this year. There are three main factors, I believe, operating on interest rates. The deficit is one of them, the one that receives greatest attention. The other two are the uncertainties being caused by the policy. It is not just the deficit itself but the uncertainty caused by the combination of fiscal and monetary policy. People just do not know how we are going to handle this problem, so they charge a big risk premium. It was conventional, a few weeks ago, to say in the financial markets we have seen long-term interest rates go from 8 to 16 percent, but they are unlikely to go to 32 percent. There are now people predicting that interest rates will reach 25 or 30 percent. Lenders charge risk premiums. We have this wide range of predictions about what will happen to interest rates. It reflects the very enormous uncertainty which is being borne by the financial markets. I emphasize the uncertainty more at the moment than the level of the deficit.

And, third, of course we have the monetary policy. We will reduce interest rates at least to some degree as we bring the rate of inflation down.

Senator **Byrd**. Dr. Fellner, you mentioned a number of places, in your statement before the committee today, of deficits.

Dr. **Fellner**. Yes.

Senator **Byrd**. On page 2, you say,

> The principal problem that now clouds the economic future is the series of vast deficits projected in the Administration's recent budget." Certainly I agree with that. And then you say on page 3, "But the deficit outlook is even worse because the Administration's revenue forecasts are likely to be proved overly optimistic.

I think that is certainly a reasonable and accurate statement.

Dr. **Fellner**. Well, I do think, Senator, that it is reasonable but it was in my colleague's statement, Dr. Martin Feldstein's, not in mine. But I do believe it's a reasonable statement.

Senator **Byrd**. I'm sorry. I beg your pardon.

The **Chairman**. Go ahead.

Senator **Byrd**. And then you say, "Sustained deficits of this magnitude are a serious burden for the economy, and result in reduced investment, increased inflation or both." I think these points need to be emphasized. Those are my words; not yours.

> Since a government deficit means increased government borrowing from the public, its automatic effect is to raise the real rate of interest and thereby reduce private borrowing and investment.

You certainly talk in my language.

And then you say, "Nevertheless, the impact of a $100 billion deficit on private capital formation is likely to be very significant." This is a significant paper.

Then you say, "The principal reason for higher market interest rates is that they are inflation." There again, it seems to me that that is totally sound.

Now then you get down, still on page 4, "The interest rate increase is also small if domestic borrowers believe that the large deficits are only temporary."

Now my question to you: In your judgment, are these large deficits only temporary?

Dr. **Feldstein**. Certainly not based on anything that Congress has done yet.

Senator **Byrd**. And then on page 6, "It is not up to Congress to broaden the range of spending reductions * * *" I agree with that. "* * * not in order to cut spending by more than the Administration proposed * * *" And I don't agree with that. "* * * but to distribute the spending cuts in a way that is both fairer and likely to achieve legislative approval." Well, I think that if there are unfair spending reductions, that ought to be let up of course. But I don't agree with you in saying it ought not to be cut below what the administration recommends. It seems to me that there has been no basic reduction in spending; there has been a reduction in the rate of increase of spending. But it is still a very high rate of increase.

Dr. **Feldstein**. If you achieved the real reductions in non-defense spending that the administration proposes over the period to 1987, and you did the other changes that I talk about in this testimony—basically, some increase in tax revenue without changing the fundamental things that you did last year, plus a slow down from 9 to 7 percent in the growth of defense spending—we could look to a balanced budget by 1987.

Senator **Byrd**. Your statement ends up on page 8 by saying, "First of all, it will take five or six years to achieve a balanced budget."

Dr. **Feldstein**. That's when 1987 is.

Senator **Byrd**. Five or six years to achieve a balanced budget. I think that is justification right there for the assertion that we are on the verge of a financial crisis. But I do want to say that I am impressed at your emphasis throughout this statement on the huge magnitude of the deficit that is facing our country today.

Just one final question. Dr. Pechman, through the years very seldom have we been on the same wave length. Most certainly, we are not today when you propose to tax social security benefits. You say that at the very end. But you also advocate repealing tax indexing. My guess is that you will prevail in that. Not this year; not next year. But in my judgment, that will never become part of the tax code. But that will become effective. I don't see how you are going to index expenditures upward and index revenues downward.

Dr. **Fellner**. No. That is a very different thing, Senator. The one has absolutely nothing to do with the other.

Dr. **Feldstein**. The indexing expenditures upward means that expenditures maintain their real value. Indexing taxes downward mean the taxes maintain their real value, so that if you have both indexed, inflation shouldn't have any impact on the deficit. Taking away the indexing of taxes means—and maintaining the indexing of benefits—means that taxes grow more rapidly than benefits because we have a progressive tax structure.

Senator **Byrd**. That's true. And, of course, the Government gains by inflation so far as taxes and revenues are concerned.

Dr. **Fellner**. That's a dreadful thing. That is really a dreadful thing.

Senator **Byrd**. I agree it's a dreadful thing.

Dr. **Fellner**. To build that into a fiscal system. That the Government has an interest in creating inflation because that makes the tax revenue rise in a higher proportion than the income of the public and the outlays of the Government.

Senator **Byrd**. The Government gains. In other words, the more inflation we have, the more the Government gains by it.

Dr. **Feldstein**. And the day the Congress votes to rescind indexing, the financial markets will recognize the bad news, and will say, ah ha, that means that Congress has a bigger vested interest in higher inflation rates in the future.

Dr. **Fellner**. Yes.

Senator **Byrd**. Now you folks are experts on this and I am not, but it doesn't seem too logical to me.

Dr. **Pechman**. I don't agree with them. I think they have exaggerated the inequity of indexation. I think it is much more important to reduce the deficits. We cannot afford indexation in the foreseeable future. I agree with you, Senator, that it should be delayed. And I don't think the roof will cave in at all. On the contrary, I think it would be quite unfair to do what Dr. Fellner says: To substitute for indexing an increase in consumption taxes, which would hurt the lower income classes.

Senator **Byrd**. Glad to know that.

Dr. **Meltzer**. Senator, may I add to that? The nonindexed tax system has not produced a balanced budget or even come close. Indexing is a way of assuring that the Congress declares that it will not balance the budget by pushing everybody up into higher tax brackets. Congress must declare that if it is going to balance the budget or even get close to balancing the budget, it is going to do it by honest maneuvers, voting for tax increases and expenditure reduction.

Senator **Byrd**. Well, that may be. But I just want to comment on Dr. Pechman's interest in a balanced budget. I don't recall that interest in the past, Dr. Pechman.

Dr. **Pechman**. I'm sorry, Senator. I would urge you to read what I have written about that subject. I have always said that we ought to balance the budget in good times, and that we should tolerate a deficit only in bad times. My statement explicitly says that, in the economic situation foreseeable in 1984, the deficit that is now projected is intolerable.

Senator **Byrd**. I'm delighted to hear that. Thank you.

The **Chairman**. Let the record show that the vote on indexing was three to one in favor. [Laughter.]

Senator Mitchell.

The **Chairman**. That's out there. Up here it might be 3 to 1 the other way.

Senator **Mitchell**. I just want to say, Dr. Feldstein, that you guess that the repeal of indexing would send different messages. That is, that the deficit would be far more out of control.

Dr. **Feldstein**. Exactly.

Senator **Mitchell**. And it would have an undesirable effect rather than desirable.

Dr. **Feldstein**. But the deficits are frightening to Wall Street because of what they say about inflation, not because of the deficit per se. One of the ways in which the deficit can create inflation is by persuading Congress to eliminate indexing, and then persuading the monetary authorities to reduce that deficit through inflating the economy, pushing us all into higher brackets and collecting more taxes. So if I were sitting on Wall Street and I read that this committee had voted to eliminate indexing, I would say that was the first step toward an inflationary route in eliminating the deficit.

Senator **MITCHELL**. Well, I appreciate what you are saying. I merely submit to you that an equal number or perhaps greater would draw the opposite.

Dr. **FELDSTEIN**. But, you see, your position, Senator, is that indexing will reassure people because it will tell them that we are not going to have the deficit. It helps to bring down the size.

Senator **MITCHELL**. No. That's not my position. My position is it won't be as large.

Dr. **FELDSTEIN**. Won't be as large. But the reason it won't be as large is because you would be counting on inflation to do the job for us of bringing down the deficit.

Senator **MITCHELL**. No.

Dr. **MELTZER**. No.

Dr. **FELLNER**. That's the only way we can along those lines.

Senator **MITCHELL**. But Dr. Meltzer says a no-indexing tax structure has not produced a balanced budget, so index as though that's the answer.

Dr. **MELTZER**. No, no. But look at the country. Look around the world, and look at countries with very high inflation. Israel.

Senator **MITCHELL**. Do they have indexing?

Dr. **MELTZER**. Yes; they do.

Senator **MITCHELL**. Brazil.

Dr. **MELTZER**. They have indexing.

Senator **MITCHELL**. Chile.

Dr. **MELTZER**. Chile does not have indexing.

Senator **MITCHELL**. Look in this country. Look at Minnesota.

Dr. **MELTZER**. How do any of those countries manage whether they were indexed or not? How do they manage to bring down the rate of inflation. It was not by trying to let inflation raise taxes. That is certainly true of Israel, and that is certainly true of Chile. It is certainly true of Brazil. It was true of Argentina. Inflation did not keep their tax rates rising fast enough to keep down their budgets and deficit, and that's why they ran into the problems they have.

Senator **MITCHELL**. Well, I want to get into a couple of others. I don't want to limit it all to indexing because we have got more immediate problems.

Dr. Feldstein, based upon the portion of your statement that Senator Byrd reread, is it fair to conclude that you disagree with Secretary Regan who came here yesterday and said, "Deficits do not cause high interest rates"?

Dr. **FELDSTEIN**. What I said in my statement and what I believe is that the deficit per se, the borrowing per se, raises real interest rates only a little bit. The primary reason for our high deficit is the fear of the inflationary policies that might occur either just to raise taxes before we index or to accommodate a deficit in future years.

Senator **MITCHELL**. So in other words, the statement left out the word direct or indirect. What you are saying is that there is a relationship but it is indirect. Does anybody disagree with that?

Dr. **Fellner**. Yes.

Senator **Mitchell**. You disagree with that?

Dr. **Fellner**. Yes.

Senator **Mitchell**. You don't think there is any relationship between deficits and interest rates?

Dr. **Fellner**. I disagree with the statement that there is no direct relationship. I think there is a direct relationship.

Senator **Mitchell**. You think there is a direct relationship?

Dr. **Fellner**. Yes.

Senator **Mitchell**. Oh, I see. So you disagree with the Secretary of Treasury?

Dr. **Fellner**. Well, I don't know what the Secretary said. Judging by the papers, the Secretary said that the increase in the saving rate will be so large that though the deficit absorbs a high proportion of the savings, what remains will still be more than we had in the past. I think he made a statement of that sort. At least that is what I read in the papers. And that isn't quite the same thing as to say that deficits have no bearing on interest rates. I think what he was saying is that he hopes to get such a high increase in the saving rate that even though a lot of that will be absorbed by the deficit, what remains will still be more than what we now have. Something of that sort came through in the papers.

Senator **Mitchell**. Well, I don't know what the paper said. I just read you what he said. I was sitting right here and I have got his written statement.

Dr. **Fellner**. Yes.

Senator **Mitchell**. Let me ask you another question, Dr. Fellner. You said that we ought not to touch income tax but we ought to increase some taxes. What taxes do you have in mind?

Dr. **Fellner**. Well, that would really require a study, a comprehensive study, and not someone who is working in a research institute and doesn't have access to the full range of materials and data that would have to be studied. But what comes to mind, among other things, is a levy on oil imports.

Senator **Mitchell**. A levy on oil imports?

Dr. **Fellner**. Yes.

Senator **Mitchell**. Aren't you concerned about that?

Dr. **Fellner**. I'm concerned about all these things, but that is one thing I would study.

Senator **Mitchell**. Yes. Well, let me ask you about the general effect. Aren't you concerned about making, within a period of a year or so, a major reduction in the personal income tax rates on the higher income persons, and then increasing consumption taxes, which are shared disproportionately upon those of lower income, that you would be effecting in our society a major shift of the total burden of taxation from the higher income levels to the lower income levels.

Dr. **Fellner**. Well, these very high marginal tax rates have developed as a result of the bracket creep. Namely, it is a result of a nonindexed tax structure due to which these marginal rates were rising all the time. Now we are making a move to prevent that from continuing. And as a matter of fact, I think we are getting at least somewhat back from the present very high rate, if you make allowance for future inflation. We may be now doing somewhat more but only slightly more. That that is an unfair measure to the low-income groups is, I think, not a defensible proposition.

Senator **Mitchell**. Well, didn't we reduce that from 70 to 50 percent? Isn't that a reduction on the rate paid?

Dr. **Fellner**. That really falls in a different category. That is not really the same thing as the general rise in the marginal rate.

Senator **Mitchell**. But then we are reducing over a period of 3 years the rate by 25 percent.

Dr. **Fellner**. I would like to see an estimate of how many people really paid those 70-percent taxes.

Senator **Mitchell**. Well, you will find that the people in the middle-income tax category paid very close to the rate on the tax table. But the higher up you go in the aggregate, the greater the gap between the rate on the tax table and the amount paid by the taxpayers. A very simple reason that we all know is that all of the available mechanisms for reducing the income tax liability are generally available only to persons at the higher income scale. Not for any legal sense, but the guy working in the mill making $18,000 a year, he is not thinking about depletion allowances. He is thinking about paying next month's oil bill.

Dr. **Fellner**. But that is still another way of saying that the reduction from 70 to 50 hasn't really made much difference in that regard. For what reason it has made not much difference, I don't know. But it has not made much difference in that regard. But at any rate, I think that high marginal tax rates—to say that those are equitable is at best half true and half untrue. Collecting these high marginal tax rates and then spending the income of the revenue of the Government for supporting the lower income groups, that is fair to those in the lower income groups who will never make it. And very unfair to those who want to get ahead and have it in them to get ahead. You make it very difficult by this very high marginal tax rate for anybody to get ahead in the income scale. So the equity considerations are very ambiguous in that regard and it is certainly a very inefficient way of handling the economy.

Senator **Mitchell**. Well, I disagree with you. But I apologize to the chairman and the other members. I went beyond my time. I am sorry, Mr. Chairman and Senator Boren.

Thank you very much.

Dr. **Fellner**. Thank you.

The **Chairman**. I think under the early bird rule, I got here before Senator Boren. I plan to stay in any event, but I wanted to ask you a couple of questions.

Do any of you think we ought to continue the all-savers provision? Do you see anything coming out of that except about $3½-billion revenue loss?

Dr. **Meltzer**. No.

Dr. **Fellner**. No.

The **Chairman**. Dr. Pechman.

Dr. **Pechman**. No, I don't think we ought to continue it.

The **Chairman**. Dr. Feldstein.

Dr. **Feldstein**. Not continue.

Dr. **Meltzer**. I would not continue although I think that there is probably some small incentive benefit there. I would say it should not be continued.

Dr. **Fellner**. Same here.

The **Chairman**. Pardon?

Dr. **Fellner**. Same here.

The **Chairman**. I'm not sure that will be helpful because we are going to have to face up to that sooner or later. And I want to say to Dr. Pechman that we are looking at all the tax expenditures in addition to those you listed. We have had our staff and the Joint Tax Committee staff looking in a number of areas, including pension where you can contribute $45,000 if you are a doctor or lawyer and have a corporation. And there ought to be some limit to what you can put away tax free. We are looking at a number of those areas as to whether we can cap some of the excess benefits in an effort to raise some revenue. But I think we run the risk, if we have a laundry list of revenue gainers—I'm not certain whether we can accomplish all that in time, to send the right signal to the right people, whoever they are.

We had hoped to come up with a package—I hope—that we would add to the debt ceiling extension when it comes to us in late April or May. And do you feel that if Congress—and I am talking about bipartisan groups, the Members of Congress—with the help of the press, would really put their minds to it, and would add to the debt ceiling extension of more or less of an economic package with substantial increases in revenue, if necessary, including some budget reductions, user fees, and we could even add appropriation cuts and other things as they did in 1968, that we would have an impact on the financial market?

Dr. **Pechman**. I think there is no question about it. I think that the quicker you make it clear that you are going to reduce the deficits out in 1984 and 1985 by at least half, the more you will reassure capital markets. And let me add that I am delighted to hear that you are examining the whole list of tax expenditures. My purpose in table 1 was not to limit your scrutiny.

The **Chairman**. No, there are a number of them. We may have difficulties on some of these things. There may be some we can agree on. I think we have problems if they become parochial—but there are some nationwide where I think we can address those.

Dr. **Pechman**. Yes.

The **Chairman**. At least I hope we can address those. Does anyone here object to modifying—I know it is tinkering—or repealing the so-called leasing provision?

Dr. **Meltzer**. Do you object to it?

The **Chairman**. We will start with Dr. Feldstein.

Dr. **Feldstein**. Well, I would welcome a chance to discuss it in more detail. But I think the leasing provision is basically a good provision, which is necessary in the long term for carrying out the intent of ACRS. And if you eliminate leasing, you will have eliminated for many high growth or high leverage firms any favorable incentive effect of accelerated equipment depreciation.

There are abuses. And I can think of ways in which I would tighten the leasing rules so they have their favorable effect without, in effect, wasting revenue unintentionally. I wouldn't eliminate the basic leasing provision.

The **Chairman**. I think there are about nine different options now under discussion on ways to tighten. One was repeal. And I would venture to guess that if you offered a motion to this committee to repeal it outright, it would be nearly unanimous. I have never seen such widespread agreement among conservatives, liberals, moderates or whatever, Republicans and Democrats. I don't say they are abusive. It is just too generous. I don't fault somebody for taking advantage of a provision at all.

Dr. **Feldstein**. I think the generosity is often thought about in terms of lessor. That an IVM or a General Electric can substantially reduce their taxes. They are not getting something for nothing, though, in this. They are, indeed, reducing their taxes, but they are simply transferring the tax benefit to others and making a very small margin on it. After the first few months, that market became a very perfect market. So people are, in effect, parading in that tax I O U from some other company. The beneficiaries are the lessees and not the lessors. One shouldn't think about eliminating this because IBM is getting a great break or GE is getting a great break. Even though they are the ones who appear to be reducing their taxes very substantially, they are merely transferring the tax benefit to the lessee.

The **Chairman**. Dr. Pechman.

Dr. **Pechman**. I indicated that I would not approve eliminating the leasing provision without substituting something else. And I am glad to hear that you are thinking of alternatives. My preferred alternative is to do something that I know is unpalatable to Congress, but I think most economists would say that an income tax law ought to have some degree of refundability of investment credits and net operating losses. I'm not sure that 100-percent refundability is either possible or desirable. But I certainly think partial refundability would be appropriate. And, also, I have the feeling that you could probably control refundability better than you can under leasing. But I am not an expert in this area.

The **Chairman**. I think one area of concern is whether or not there is any confidence in what Congress will do. We can all attack the President's budget as being irresponsible. And I heard one of my colleagues on TV last night saying that this is the first time in history that everybody in Congress was opposed to the budget. Well, it is probably the first time in history we have been cutting programs. In every other budget sent up here, it is seeing how many billions we can spend of taxpayers' money we didn't have. I don't think that is a valid criticism, but it is enough to get you on the nightly news. Well, I won't get into that.

But do you have any confidence in Congress? Would anybody here give us a vote of confidence? Is there anybody in the room that would give us a vote of confidence? [Laughter.]

Dr. Pechman, do you think we will do what we should do?

Dr. **Pechman**. I have a feeling, just reading the newspapers and looking at the nightly news, that Congress is aware of this fiscal crisis. And that you are going to do something about it. I don't think you could face the electorate in the fall unless you did something very, very significant. I am hoping that you will examine the budget very carefully and go beyond what the President recommended.

The CHAIRMAN. Dr. Fellner, thank you very much. I hope your leaving is not a total lack of confidence. [Laughter.]

Dr. FELLNER. I really didn't know it would last this long. Thank you very much.

The CHAIRMAN. Thank you.

Dr. MELTZER. I would not hazard a guess as to what Congress will do in 1982. I will guess that at some point Congress will do something about the budget problem because unless something is done, the deficit will continue to rise. And I think that the important consideration for Congress is, of course—despite the fact that this is an election year—is that there is an opportunity for leadership in putting together a package which goes across many, many different constituencies. If Congress doesn't do anything this year, then in certain areas, it becomes much harder to do something next year and the problem just gets pushed into the future. I think you are all familiar with the military problem where cutting obligational authority doesn't do very much for you in the near term, but it does a lot for you in the long term. And we should begin to make those changes, I believe.

The CHAIRMAN. As I traveled around the country, I think that is one question that was asked of me. Will Congress do anything or what will Congress do? It has got to be a part of the equation somewhere. Certainly, you need to know how Congress responds.

I will just ask one more question and then I will look to Senator Boren. We've been told that most people discounted the 1982 deficit. Is that generally agreed?

Dr. MELTZER. Yes.

Dr. PECHMAN. Yes.

The CHAIRMAN. So is it all right to put a few more billions in there?

Dr. FELDSTEIN. No. Well, I would entertain accelerating the tax cut that will go into effect on July 1, 1982. I would object, however, to making it retroactive to January 1. I think that is just increasing your deficit without getting anything for it. I would make it prospective. And if you could act by April 1, you would get 3 months of stimulus, which I think would be neat.

The CHAIRMAN. How about the revenue?

Dr. MELTZER. Senator, I would like to say that any effort to raise expenditures at this time, unless it is accompanied by some sign that there is really serious action, not discussion, but action taken about the future deficit, will, I think, send exactly the wrong signal. That is true on both the tax side and the expenditure side. If you are going to do something to accelerate spending or to alter the tax cut, it ought to be part of a package in which the future deficits are reduced by a meaningful amount.

The CHAIRMAN. Do I infer from your statement, Dr. Feldstein, that you are not so concerned about the 1983 deficit?

Dr. FELDSTEIN. No. Remember what I said was I would postpone the 1983 tax cut to 1984 and 1985. I think it is important.

The CHAIRMAN. Because that just takes pressure off Congress to do anything responsible. If we can find some painless way like deferring a tax cut that people don't have, we can pile up a big savings.

Dr. **Feldstein**. Well, you don't pile up a very big savings for fiscal 1983 since it's only 3 months of a 10-percent tax cut, about $10 billion. The main thing is in 1984, it reduces pressure. But on the capital market, it means we don't have as much crowding out. But I certainly wouldn't want to do it if the implication of doing it was that we would simply spend that much more. I think it is terribly important also that if it does get postponed, it gets postponed for an explicit date. Although even that, I recognize, runs the danger that you can then postpone it again for another explicit date.

The **Chairman**. That wouldn't give the taxpayer much hope.

Senator Boren, unless someone here is under some time constraint about going to lunch or dinner——

Senator **Boren**. I will try to be brief so that we don't keep them past the dinner hour.

How would all of you react to the general suggestion that we ought to follow a tax policy which penalizes consumption more, and which rewards savings more? In other words, expands the opportunity for further tax exemptions in the savings area to get the pool of savings up. And would put further tax burdens on consumption. As a general policy statement, would you agree or disagree with that?

Dr. **Pechman**. Well, I don't think I would go that route at present, particularly when we have the vast amount of dissaving in prospect by the Federal Government. Right now we are facing what will essentially be a full employment deficit of 4 percentage points, which cuts into total private saving by a factor of about 25 percent. If you balance the Federal budget, say, 3 to 5 years out, I think you would have a satisfactory amount of national saving, and productivity growth. If, at that time, the country decides that it wants to grow faster, then the only way that I know how to do it would be to reduce the emphasis on income taxes and increase consumption taxes. But there, you would be hitting into the equity question. My guess is that I would not vote for a change of that sort, provided, of course, we are growing at a satisfactory rate.

Senator **Boren**. I suppose in theory, you could approach the equity question by the way you waited, the types of articles and so on. Primarily, luxury taxes.

Dr. **Pechman**. No. The only way you can really tax consumption adequately and fairly would be to introduce a graduated consumption tax.

Senator **Boren**. Uh huh.

Dr. **Pechman**. I don't think you could simulate the kind of progressivity you have in the income tax system by way of value added tax or a sales tax. That, essentially, is a flat rate tax, even if you eliminate necessities. So the alternative is a graduated consumption tax, and I certainly don't favor that.

Dr. **Feldstein**. I agree that we should have—I agree with you, Senator—more emphasis on savings incentives. And I think Congress made a major step in that direction with the IRA's last year. I think that raising the ceiling from $2,000 to higher limits would not be a program that favored the rich in any sense. If one took it from $2,000 to $3,000, it would basically be favoring middle-income savers. And it would be turning what, for some people, is a reward but not an incentive because they are going to do $2,000 anyway, into more of an incentive because it raises the ceiling for them. I think the cost of that is very small. And when Congress finds itself in the position where it can think about any loss of revenue, that would be very high on my list.

Senator **Boren**. You think, for example, when the all-savers expires that we ought to perhaps consider putting whatever the revenue cost of something like all-savers are into other forms of increased saving incentives, be they IRA retirement or be they other kinds of retirement funds.

Dr. **Feldstein**. Yes. And I don't remember the exact status of that 15-percent interest exclusion that is scheduled to come in 1985.

Senator **Boren**. No.

Dr. **Feldstein**. I remember that that was intended, in some sense, to follow on when all-savers is saved out.

Senator **Boren**. Uh huh.

Dr. **Feldstein**. But I think it is there in any case.

Senator **Boren**. Yes.

Dr. **Feldstein**. So I would say that the extra revenue that you save by eliminating all-savers ought to be directed to either expanding that or raising the limits on the IRA's.

Dr. **Pechman**. Let me say that I just couldn't disagree with Martin Feldstein more on the IRA's.

Dr. **Feldstein**. You couldn't disagree with me more on this than on other things?

Dr. **Pechman**. Than on other things, right.

Dr. **Feldstein**. That is the limit. [Laughter.]

Dr. **Pechman**. Martin has heard this before. On January 4—I think that was a Monday—my wife and I each transferred $2,000 from one account in a mutual fund to another called IRA. It happened to be a money market fund. We didn't increase our saving by one dime. And we got, essentially, a $1,000 tax cut for just making this transfer. I predict that the increase in saving resulting from your action on IRA's last year will be very, very small. And that the benefit of it will not go to the low- and middle-income classes, but will go to rich people like Martin and me, and the people sitting in this room.

Now if you want to have a saving incentive—I want to repeat—you are going to have to tax consumption or give a deduction for net saving. In other words, you have to avoid the possibility of transferring or borrowing funds. I don't know of anything in the tax law yet that does that. As I indicated earlier, I am against doing that. But I think you ought to eliminate the savings incentives, which are graffiti in the tax law and do more harm than good.

Dr. **Meltzer**. Let me speak as one of the poor, because Joe excluded me from the group of rich that included Joe and Martin, and properly so. He made the mistake of confusing marginal and average tax rates. Of course, there are going to be people who will do exactly what he said. But I am sure the Congress was aware of that when they passed the law. At issue is not whether somebody will take advantage of the tax exemption and put some long-term saving into an IRA; at issue is whether there will be some people who have not saved at all who will now save. My estimate of what is going to happen to the saving rate is that we will see, as Secretary Regan said, a substantial increase in the saving rate this year because of the IRA's.

Let me give you some good evidence of that. The kinds of shifts that we have been talking about here are the kinds of shifts which took place in Britain. They lowered the progressivity of the tax system. They put some taxes on spending. The saving rate jumped before the recession began. And the saving rate has remained high in Britain. Their problem, like ours, has been that the deficit has also remained high, so a lot of that savings is absorbed by the financing of the deficit.

Dr. **Feldstein.** Canada is another good example of a country that introduced these kinds of savings incentives and saw a very big increase in their savings. But on the proposition that the Pechmans saved $4,000 and got a tax break, that argument would suggest that one shouldn't have an investment tax credit either because I bet there are some people who made investments and got the ITC who would have made those investments even if the ITC hadn't been there. We know that is true about any kind of incentive. That it doesn't have an effect on absolutely everything that gets a tax benefit.

Dr. **Pechman.** May I just interrupt on that? When the investment credit was enacted, I opposed it because I thought it would be wasteful; I supported a net investment credit at that time. And I have the same view with respect to savings.

Dr. **Meltzer.** I think Joe is making a very strong argument for raising the maximum level for the IRA. Because when we get up to the level at which Joe will save more, we will have a big increase in savings.

Dr. **Feldstein.** Well, we don't have the facts on the distribution of the number of people who currently save at least $2,000 per person or $4,000 per working couple. But extrapolating the best earlier information that we had indicates that very few people are already at the limit. Perhaps 20 or 25 percent of people are. And for them, they are in the Pechman situation; they get a reward for doing the saving anyway. But the rest of the population, it's a net incentive.

The **Chairman.** How can you refuse? You watch some of these TV ads and you are going to be a millionaire if you put a little nest egg of $25 a week or something like that.

Senator **Boren.** Let me ask you another question, Dr. Meltzer. Now in following up on your comment, I agree that we have built into the interest rates now an uncertainty premium. I think that is a real factor. Both uncertainty as to monetary policy and uncertainty as to the future side of the deficit. Crowding out. It also reflects the future anticipated inflation so that your long-term rates are probably being padded here, whether it's by 2, 3, or 4 percent. It's a very significant risk factor minimization type fishing that they are trying to get here in the interest rates.

You criticized very sharply the monetary policies and the failure to stay within target. And the uncertainty that adds in addition to uncertain fiscal policies. What would be your suggestion, if you were making suggestions to Mr. Volcker in the Fed, in terms of changes in policy that might enable them to stay more within their targets? What kind of changes in the operation would you suggest?

Dr. **Meltzer**. Let me just preface my remarks with two others. I want to go on record as favoring your consumption tax or favoring the shift from income to consumption taxes for the reasons that I think Martin Feldstein laid out. And I would like to say that I do not believe that crowding out is not a problem. Crowding out is a problem for the United States, and I have emphasized that for many years.

Senator **Boren**. What if we get to a $2 trillion debt by 1986 or 1987 instead of a $1, I gather we would have severe problems.

Dr. **Meltzer**. I think it's a problem in 1983 and 1984. But I don't think it is the main reason why interest rates are high. And I don't want to be misinterpreted when I say that.

Senator **Boren**. Right.

Dr. **Meltzer**. All right. As far as the monetary policy is concerned, I believe that we could have a significant drop in interest rates if we would reduce the variability of monetary policy. How could we reduce the variability of monetary policy in the United States and the uncertainty? The simplest thing is let the Fed set a target that it can control. Something on its balance sheet. Let it not try to aim at any of the money stock. Let it stop trying to control interest rates or to set its targets in relation to interest rates. Let me briefly expand on that.

Senator **Boren**. How would that work?

Dr. **Meltzer**. The Fed now tries to figure out what money growth will be by estimating what the interest rate will be at which the demand for money and the supply of money cross. It then tries to estimate how much banks will borrow. Those relationships are in the short-term, very much less than air tight. Consequently, the Fed makes errors. They underestimate how much borrowing there will be in the economy. They underestimate what they call the demand for money in the economy. They think they are going to get stable growth of money and then they get a bulge in money. Now they have to decide, is that temporary or is it permanent? Should they take it out? Just exactly the problem they face now. Should they take the bulge out now; should they let it stay? Will it correct itself? Another week goes by and we get another bulge. And then another week goes by and pretty soon people begin to build up their inflationary expectations. Interest rates begin to rise and borrowing begins to rise. And then the Fed decides, well, maybe the bulge is there longer than we thought it would be. They crack down on the money stock. And that puts a lot of variability in money and interest rates.

What I would do instead is simply this: They have a balance sheet. The recommendation we make is simply control the size of their balance sheet. If they control the size of their balance sheet, which they can read every day, they will have no problem with variability. That doesn't mean that interest rates will be perfectly stable. It means that they will be more stable. The market will know. If I were in charge of the Fed now, I would announce what the growth of reserves or base money the balance sheet is going to be for the next 3 months. And I would hit those targets for the next 3 months. Then people would have confidence that I can achieve the targets I set. If the Fed did that for 3 or 6 months, I believe the greater part of the risk premium would go away.

Senator **Boren**. You think you would have much less fluctuation?

Dr. **Meltzer**. Indeed. Indeed. And a lower level of rates.

Senator **Boren**. Lower level.

Dr. **Feldstein**. I just want to say that I agree with what Allan says but I would pose a question that really reflects an uncertainty in my own mind to him. And that is, there are two kinds of uncertainty. There is this kind of uncertainty that you have been talking about: What is the Fed going to do the rest of this year and so on?

Dr. **Meltzer**. Right.

Dr. **Feldstein**. And then the other question is: What are they going to do in 1984 if we still have an $80 billion deficit?

Dr. **Meltzer**. That's the budget problem.

Dr. **Feldstein**. And does this raise the credibility—does what you are suggesting—raise the credibility of the Fed statement that come what may, they are going to stick with a certain growth path for monetary base or available——

Dr. **Meltzer**. Only the Congress and the President can take out that uncertainty. I would like to say one last thing on that subject. That is essentially what the German Central Bank does and for that reason, among others. They did not try to target M-1 or M-2 or M-3. They chose the size of their own balance sheet. One reason they did that was because they wanted a target that they could hit.

Senator **Boren**. It has worked much better.

Dr. **Meltzer**. It has worked much better.

Senator **Boren**. Until they started being so severely impacted by our end.

Dr. **Meltzer**. By our interest rates, and also their own very large budget deficits.

Senator **Boren**. Do you agree with that also?

Dr. **Pechman**. I'm not a monetary expert so I will pass.

Senator **Boren**. OK. I understand that. That's very helpful. Let me ask you this question. I was a little shocked about hearing the discussion on indexing. It seems to me that you talk about uncertainty and you talk about expectations and psychology—the financial community has to be looking at the fact that all of our spending is indexed to go up, and our income was indexed to go down. And, therefore, this gap-creating deficit is going to grow.

Dr. **Feldstein**. Let me try again on that. I didn't do it very well last time. The spending is indexed to go up in proportion to prices. Taxes, if they are not indexed, go up more than proportion with prices. And indexing cuts back that excess so that they only go up proportionate to prices.

In other words, if you have both spending and taxes indexed, they both rise in proportion to prices. Real taxes, real spending don't change. There is no widening deficit. If we started with a balanced budget, having indexed spending and indexed taxing would not lead up to a deficit. The issue is do you want to use an unindexed tax system as a way of raising the tax share, bracket creep.

That is not going to effect the very rich. They are not going to be basically effected by bracket creep.

Senator **Boren**. Yes. I see what you are saying and that is a very good additional point.

Dr. **Meltzer**. Senator, may I just add one thing. It leaves, and I am sure Marty would agree, a problem. If you start the indexation with a very big deficit, you are not going to get rid of the deficit that way. You still have to take down the spending rate.

Senator **Boren**. If you could get the deficit in place and perhaps we could do something along those lines. I don't know. I guess I have to say—I agree philosophically with what you are saying in terms of the fact that holding the indexing would merely keep you in place for the tax system and not have it grow and holding down inflation. I think, to me, having everyone see that the deficits are definitely going to shrink becomes even more important than holding to that principal at this point. The political realities are that most observers, probably realistically, doubt that Congress will do enough in terms of cutting the spending, bringing down into a balanced budget, that we would then have with on the kind of tax policies that you are talking about. So I am not so sure I would burst ahead with them.

Let me ask you this question: Let's suppose you could strike a deal that would say that all references to indexing in the law period—all of them. Pension funds and retirement programs, Government spending of all kinds, including social security, including indexing the taxes. In other words, all references to indexing in the law across the board everything—could be removed, that would include tax indexing as well as spending indexing, under the argument that there is some equity in that and that Congress ought to, on an annual basis, as most of our States do—we fought this in our State and I opposed and vetoed several bills that had anything like indexing in—I vetoed on the theory that the legislature should do the job each year. We operate under a budget balancing amendment, we should each year meet our responsibilities, set the priorities, try to do so with equity. And, of course, I always said we will try to help the senior citizens as much as we can afford each year on an annual basis.

Would you be willing to make that kind of bargain if we could remove all indexing references to law. Would you be willing to bargain away indexing in the tax law as well?

Dr. **Feldstein**. I wouldn't. I think it would be a mistake. I think there are certain programs, particularly the social security program, where explicitly or implicitly you have to have indexing.

Senator **Boren**. Why?

Dr. **Feldstein**. Basically, you make a promise to all people that they can retire at about age 65. With the kind of benefits you are currently giving them, you make a promise that they can retire with very little in the way of assets of their own and then you say you have to take your chance. We have a lot of inflation, your benefits won't be worth much unless we decide we want to give it to you. And if you don't have a lot of inflation, you will get a certain monthly check which will have the value that it had when you retired. Well, you can't do that, I think. That is why Congress de facto indexed up and down in the past. And then in 1972 started formal indexing.

Senator **Boren**. Well, you would say then that the reason we got into problems because—because if you are going to index the taxes, you are going to keep the income tax from gaining ahead of inflation, you continue to index the benefits, spending. This is where we have gotten into such trouble.

Dr. **Feldstein**. No. We got into trouble not so much from indexing—we got into trouble because we raised the share of nondefense spending by 5 percent of GNP, from 13 to 18 percent, over a decade.

Senator **Boren**. When you say nondefense spending, you are not including entitlement programs?

Dr. **Feldstein**. Yes, I am. Including all nondefense spending. That $550 billion current figure was raised from 13 percent of GNP in 1970 to 18 percent of GNP now. A small part of that is due to indexing in excess of what otherwise would have been done on an ad hoc basis to keep social security retirees whole.

Senator **Boren**. Well, would you support the proposal then that we go to the wage—not to exceed the wage index in terms of social security?

Dr. **Feldstein**. Yes. I think there's a case for that because that really introduces very little uncertainty in comparison to the uncertainty——

Senator **Boren**. Over about a 3-year period because of the unusual divergence of the CPI and the wage index, it has contributed greatly to our immediate problem of social security.

Dr. **Feldstein**. But it's not a way of solving any of the social security problems or the general budget problem in the future. I think to do that, you have to take it on head on.

Dr. **Pechman**. May I add just one point?

Senator **Boren**. Yes.

Dr. **Pechman**. I really object to saying that a major source of our problem has been indexation on the outlay side. The source of our problem in the next 3 years is the fact that Congress and the administration went on a tax cutting spree. Last year, you reduced taxes by $150 billion in 1985 and you couldn't afford it.

Dr. **Feldstein**. I am sure, Joe, you and I disagree on that even more than on IRA. [Laughter.]

Dr. **Pechman**. Yes, we do disagree on that. But I want to emphasize that we would have been better off if you had not passed the 1981 act, and if you had just let taxes go the way they were and deferred action on taxes until you could afford it. But you didn't. And I think that that was a gross fiscal blunder.

Dr. **Feldstein**. But that would have meant raising taxes.

Senator **Boren**. I have to say I don't agree with that because I think you have capital formation problems.

Dr. **Pechman**. You haven't gotten any additional capital formation, you have got reduced capital formation as a result of your action on the tax cut.

Senator **Boren**. Are you talking about Federal tax cuts or——

Dr. **Pechman**. I'm talking about the entire package. I was supportive of the business tax cut, incidentally. I think probably that should have gone through.

Senator BOREN. You are talking about the individuals.

Dr. PECHMAN. Yes. If I had my druthers, I wouldn't have taken any action to reduce the individual income tax last year. Furthermore, I predict that the rate of growth of capital in the next 3 years will be lower than it has been in recent years because of the deficit that was created last year.

Senator BOREN. If Government spending grows—let me just ask you this question—as a proportion of our gross national product—it has grown every year for the last 8 or 9 years or whatever—isn't it obvious then that the capital formation must shrink? And it is very likely it will shrink if Government spending is a percentage of gross national product unless you are willing to cut back on consumption.

Dr. PECHMAN. That's right. You can raise taxes to reduce consumption to make room for investment.

Dr. MELTZER. Let me put it this way. You are going to make it much harder to increase capital formation if you are going to allow Government spending to grow faster than the gross national product. And that undoes some of what I think is given Joe Pechman's recent statement gives the wrong impression. He starts with the 1981 tax changes. Over the decade of the 1970's, the economy grew more slowly. The oil shocks came, we analyzed those shocks incorrectly; we introduced programs that pumped up consumption and Government spending. We pushed all the burden of slow growth into investment. The 1980 tax program tries to undo some of the damage that was done.

Senator BOREN. Well, let me ask one last question, Dr. Pechman. Where would you cut the spending? If you don't want to touch the indexing, where would you cut spending?

Dr. PECHMAN. Well, I would limit the adjustment on the outlay side to the increase in wages or prices, whichever is lower. I would also take a very hard look at defense spending. I can't believe you couldn't reduce defense spending in 1985 and 1986, say, by 10 percent, and still have an adequate defense program.

I object to cutting back on medicare and medicaid and other things that are in the Reagan budget. I think that user fees ought to be eliminated. And there are some other direct expenditure programs I would eliminate. But on the whole, it seems to me that the major problem is that we are trying to increase defense spending and reduce taxes at a time when we can't afford it.

The CHAIRMAN. Well, I thank the panel very much. I hope it's all right to submit some questions in writing. I think we have some areas we would like to touch on. Particularly, whether or not you support the Administration's minimum tax on corporations—whether that coupled with leasing is going to sop up most of the business tax cut dollarwise. There was some question raised about that.

The CHAIRMAN. Whether or not you think we could reduce the long-term capital gain holding period from 1 year to 6 months. What impact that would have. Plus or minus. Your thoughts on that. And some other areas that we would like to cover.

I will just ask Dr. Meltzer: Your disagreement with the Fed policy is not as strong as some of the supply siders who have called for Mr. Volcker's resignation.

Mr. **Meltzer.** I think Paul Volcker's statements are good. I don't think it is a personal issue and I don't think it should be personalized. I think Paul Volcker, under present circumstances, is making an effort to get the rate or growth of money stocked down to noninflationary levels. I disagree with the way in which he implements his policy, but I don't believe that his resignation would solve the problem.

The **Chairman.** How big was that bus that went down with the—how many seats were on that bus that went down with the supply siders?

Dr. **Meltzer.** Not enough.

The **Chairman.** Well, I am thinking maybe that three empty seats might hold all of them now if you went around Washington. [Laughter.]

You might need only a very small bicycle to take care of them. There may be one in the White House. I haven't checked.

Well, we will send you a number of questions. And we appreciate very much your patience. And Senator Boren will be happy to sign your luncheon check.

[Whereupon, at 1:36 p.m., the hearing was adjourned.]

ADMINISTRATION'S FISCAL YEAR 1983 BUDGET PROPOSAL

TUESDAY, MARCH 9, 1982

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 10:06 a.m., in room 2221, Dirksen Senate Office Building, Hon. Robert Dole (chairman) presiding.

Present: Senators Dole, Danforth, Chafee, Heinz, Durenberger, Byrd, Bentsen, Moynihan, Baucus, and Mitchell.

[The opening statement of Senator Bentsen follows:]

OPENING REMARKS OF SENATOR LLOYD BENTSEN

Parts of this budget seem pennywise and pound foolish. What do we gain, for example, if you save a nickel by abolishing a program that helps people go to work and get off welfare, then have to spend $5 on higher welfare costs?

You are proposing budget cuts, Mr. Secretary, that in some cases will result in higher costs.

Let's take WIN, the Work Incentive Program, as a case in point.

You want to abolish it and, in the words of your budget document, "give the states greater flexibility to develop public and private job settings for welfare recipients than WIN does."

I must say, Mr. Secretary, that's a very cynical statement in that budget document. It says this Administration will give the states "greater flexibility," when in reality the outcome of these proposals if they are enacted will be to force state after state to drop efforts to encourage Americans to find work.

The claim is that the states will have greater flexibility by dropping WIN and then using their Social Services Block Grant to fashion a word program of their own. The fact, though, is that the Social Service Block Grant program is up for a half-billion dollar cut in this budget. What kind of "flexibility" is that?

What this budget really does, Mr. Secretary, is abandon efforts to get people off welfare and into jobs.

Historically, since it was established in 1967, WIN has done a great job getting Americans off welfare rolls and onto employment rolls. It has consistently curtailed the rate of growth in AFDC, Aid to Families With Dependent Children.

Between 1960 and 1965—the years before WIN—the number of people on AFDC rolls increased by 30 percent, the cost of the program went up by 35 percent.

It took a few years for WIN to get up a full head of steam, but when it did it really had an impact. Between 1975 and 1980 the number of AFDC recipients actually declined by 3 percent and the cost of the program was reduced 12 percent.

And now your Administration comes along, Mr. Secretary, and wants to wipe out this very successful program.

In fact, this year's budget appears to reverse what I believe was your position on WIN last year, Mr. Secretary.

Let me, if I may, quote back to you some of your words in testimony before this committee last year. You said it was the intention of the Administration to—and I quote—"strengthen the work requirements in the AFDC program" because "the American public is not willing to bear the burden of supporting people who can work."

What has happened in the months since then to change your mind, Mr. Secretary?

Again I quote, from your testimony of last year, "Everyone who is receiving assistance who is capable of working should be involved in a work program."

Last year you assured the Finance Committee that the proposals endorsed by the Administration would—quote—"increase the self-esteem and work experience of many recipients and promote self-support through jobs in the regular economy."

I agree with your testimony of last year, Mr. Secretary. I agree wholeheartedly with this next quote. You said the work program would also—and I quote—"eliminate current abuses in the program and, more importantly, lessen the burden of providing public assistance to those in need."

That's very true. It was true last year. It is true today. WIN, indeed, lessens the burden of providing public assistance to those in need.

When you have a successful program for lifting people up and out of welfare and helping them find a job, it not only helps those people, it helps hold down government costs.

Every time unemployment goes up by 1 percent the federal deficit goes up by $25 billion. The same principle is true here. You help an individual find work and go off welfare and you not only reduce AFDC payments but the person who is working is able to pay taxes.

What is the rationale for cutting out WIN, Mr. Secretary? Why have you, over the past 12 months, changed your mind about this program which seems to be doing a great job helping people find jobs? If you eliminate this program do we have any assurances that the states will take on the expense of finding jobs for welfare recipients—especially in light of cuts in the Social Services Block Grant program? Or, does the Administration also plan to ask Congress to do away with AFDC work requirements?

The CHAIRMAN. There are other members on the way, Mr. Secretary. But I think in the interest of time, since some of us need to depart a bit early today to meet with the President, we will proceed with your statement.

Let me say, first of all, we are very pleased to have you before the committee. I'm hopeful you can tell us how we can save a few billion dollars. We believe this committee is prepared to meet its responsibilities on both the spending side as well as the revenue side if given the appropriate or proper ways to do that. I know you will have some excellent ideas.

So we welcome you back to the committee. You may proceed in any way you wish. I know you have some charts you would like to go over, which I think would be very helpful to members of the committee and members of our staff. So, Mr. Secretary, we are happy to have you here.

Senator Chafee, do you have any statement you want to make?

Senator CHAFEE. Mr. Chairman, do you have an opening statement of your own?

The CHAIRMAN. No, but I would be very happy if you gave one. [Laughter.]

Senator CHAFEE. In lieu of yours? [Laughter.]

I did have a couple of remarks, Mr. Chairman, but first I want to join in welcoming our compatriot and former colleague, the Secretary here.

There are three areas that I am particularly interested in hearing about today. The first is preventative health. The second is the effect of the proposed changes in medicare and medicaid on the recipients. And the third is the incentives to be provided in the program.

We are all looking to reduce costs. At the same time, I know you share our concern that any reductions be rational and compassionate. It seems to me, emphasizing preventative health is our best opportunity to reduce the costs.

Nowhere, I believe, is preventative care more important than in the pregnancy and the early years of life. The Federal commitment to maternal, child health, and nutrition programs recognizes this fact. So, I am eager to hear the administration's justifications for the proposed block grant including the maternal and child health and women, infants, and children programs. Maybe you won't touch on that subject today. If not, certainly we will look forward to when you will bring that forward.

Also, I am interested in hearing how the copayments and their use under medicaid will affect the use of the health care system by poor individuals. Will copayments discourage individuals from using the medicaid when they really need it?

Finally, what also troubles me is that few, if any, rewards exist to those providers who hold down costs. You and I have discussed this (on occasion), Mr. Secretary, but, particularly in the medicare area, where are the incentives? It seems the medicare system has no such incentives. Perhaps you will propose some; I will be particularly interested in these ideas.

So, we look forward to hearing your testimony and are grateful that you came, Mr. Secretary.

Thank you, Mr. Chairman.

The **CHAIRMAN**. Senator Bentsen.

Senator **BENTSEN**. Thank you very much, Mr. Chairman.

Mr. Secretary, in looking at this budget, my concern is that in a number of instances you are proposing some cuts that will actually end up costing us more and will end up keeping more people on welfare.

Let me cite a specific. Let's take the WIN program, the work incentive program; I think that is a case in point. You want to abolish it and, in the words of your budget document, "give the States greater flexibility in setting up their own programs."

Now, I really think that is a very cynical statement; because when you turn around and look at the other part of the budget, where you drop WIN, then you take the social services block grant, and you say for them to have a program of their own with that, but as I read this budget you are talking about cutting that by a half a billion dollars, now what kind of flexibility is that?

What this budget really does, Mr. Secretary, is to abandon efforts to get people off the welfare rolls. Historically, since it was established in 1967, WIN has done a great job of getting Americans off of welfare rolls and on to employment rolls. It has consistently curtailed a growth in AFDC—in the aid to families with dependent children. Between 1960 and 1965—and those were the years before WIN, before the work incentive program—AFDC rolls increased by 30 percent and the cost of the program went up by 35 percent.

Now, it took a few years for WIN to develop a head of steam, but it finally did, and it really had an impact. Between 1975 and 1980 the number of AFDC recipients actually declined by 3 percent, and the cost of the program was reduced by 12 percent.

And now your administration comes along, Mr. Secretary, and wants to wipe out what is a very successful program. In fact, this year's budget appears to reverse what I believe was your position on WIN last year.

Let me, if I may, quote back to you some of your words in testimony before this committee last year. You said it was the intention of the administration to, and I quote, "strengthen the work requirements in the AFDC program, because the American public is not willing to bear the burden of supporting people who can work." What has happened in the months since to change your mind, Mr. Secretary?

Again I quote from your testimony of last year: "Everyone who is receiving assistance who is capable of working should be involved in a work program." And I agree with that.

Last year you assured the Finance Committee that the proposals endorsed by the administration would, and I quote, "increase the self esteem and work experience of many recipients and promote self support through jobs in the regular economy." And I agree with that testimony of last year.

And I agree wholeheartedly with the next quote. You said the work program would also, and I quote, "eliminate current abuses in the program and, more importantly, lessen the burden of providing public assistance to those in need." Now, that's true. It was true last year; it is true today. The work incentive program lessens the burden of providing public assistance to those in need.

But then to turn around and say you are going to let them have more flexibility in the States, and then cut that block grant by half a billion dollars, now that just doesn't add up to me.

The CHAIRMAN. Senator Heinz, do you have an opening statement?

Senator HEINZ. No, Mr. Chairman. Thank you.

The CHAIRMAN. Mr. Secretary, I think that is an indication of our concern and our willingness to do the responsible thing. That has been expressed by Senator Chafee and Senator Bentsen and, I hope, by myself.

We will be happy to hear what you propose. Then we will follow the early bird rule on questions proceeding as quickly as we can.

STATEMENT OF HON. RICHARD S. SCHWEIKER, SECRETARY, DEPARTMENT OF HEALTH AND HUMAN SERVICES

Secretary SCHWEIKER. Thank you.

Mr. Chairman, Senator Bentsen, members of the committee, it is a pleasure to be here today to discuss the portions of the President's budget for fiscal year 1983 that concern the Department of Health and Human Services and that are within the review of this committee.

The budget we present for fiscal year 1983 builds upon the new course we began last year: it is based on helping those most in need, a new partnership with the States, fiscal responsibility, reform of the entitlement programs and regulatory relief.

We will maintain our leadership role in health research, disease prevention, and control. We will confront the hard facts of health care cost inflation.

Overall, the 1983 budget for Health and Human Services will total $274.2 billion in outlays, an increase of $20 billion or 8 percent over 1982. Our share of the budget will increase to 36 percent—still more than all 50 States combined—more than the budget of any nation on Earth except the United States and the Soviet Union, and $56 billion more than the defense budget.

One year ago, the cruel reality of inflation and the harm it was inflicting prompted the American people to demand that their Government adopt spending reforms. Today it is even more imperative that we utilize discipline in Federal spending, stemmming the rate of growth in HHS programs, thus helping reduce inflation.

The major sources of growth have been in social security and the medical entitlement programs, which have risen from negligible levels to the single largest source of budgetary growth in this decade.

Significant progress toward reform was made in the landmark Omnibus Reconciliation Act of 1981, in which the Congress for the first time used the full leverage provided by the Budget Act to shepherd significant entitlement changes through to final enactment. Much more, of course, remains to be done.

Under our proposal, social security benefits will continue at current levels with full cost-of-living increases; the budget makes no major recommendations concerning social security benefits or financing, pending the report of the National Commission on Social Security Reform.

Head Start's service to disadvantaged children will be continued, as will our emphasis on preventive medicine and health promotion, making "wellness" as pivotal as treating sickness.

Mr. Chairman, I would like to just point to a few charts that I think might outline well the points that I am trying to make without going through my whole statement.

[Showing of charts.]

Secretary SCHWEIKER. The first chart here shows our agenda and our list of accomplishments. The agenda that we went to, in terms of my tenure as Secretary, was to put wellness at the top of that group.

I have a task force working on structuring the NIH in a way that we have a coordination of information for basic data research on health prevention, and we are to have a report and a status announcement shortly on that.

I have set up a Public Health Service task force with medical schools to focus their curriculum on wellness in health prevention as well as on disease. They have been very cooperative and helpful in changing their curriculum attitude about this.

We are beginning a program with some of the private sector groups, including the March of Dimes and our Healthy Mothers Campaign, the Red Cross with its Hypertension, Atherosclerosis Campaign, and the Advertising Council of America with a general educational program on wellness.

As you saw on the cover of one of the leading news magazines yesterday, we have our sodium-labeling proposal. It is in high gear, with I think an unprecedented emphasis on the fact that sodium plays a key role in hypertension and diseases of the heart.

Private sector programs are also being encouraged on incentives that we are working on in terms of fitness with the various companies involved.

[Change of charts.]

On consumer choice and competition proposals, we have an agenda of several items, one of which goes before the President tomorrow in our Cabinet Council meeting to hopefully get our consumer choice options there.

One of the options being considered is a voucher system that would give, as Senator Chafee mentioned, an incentive to companies to compete, to gain from some profit advantage if they are able to, or to compete in the marketplace with other companies in bidding for their business under medicare, with a proviso that these vouchers must provide a floor equal to current benefits.

We also have a cost-sharing proposal with a catastrophic plan, something that our senior citizens have not had an opportunity to have in terms of catastrophic protection, and a proposal relating to the tax deductions of private insurance with tax rebates as an incentive feature.

[Change of charts.]

We did continue our NIH research. As you well know, we have 52 Nobel Laureates that have either received awards—Nobel Prizes—because of their work there or have been given grants that got that recognition for them from the NIH.

[Change of charts.]

Deregulation? Of course, we have worked with this committee in terms of block grants to States, phasing out the Federal health planning role, and we are working on the drug lag. This year, for the first time, we have set a new record on the number of new drugs that have been approved by FDA—some 27. We hope to have a task force report very shortly to even expedite that process.

We have saved about $2 billion in the waste, fraud, and abuse area. One of the key areas has been the computer match of people who are deceased and who are also receiving social security and black lung benefits. As simple as that may sound, it had never been done before. We are continuing a computer match in that area.

We transferred some eight Public Health Service hospitals and a number of clinics to the private sector. And instead of just shutting them down, in most cases we were able to have them utilized by the private sector. In Seattle, in Baltimore, in New York, communities took them over. In Louisiana, State administration took them over for child usage. I am delighted that we were able to take them and put them in the private sector and no longer have them on the Government payroll.

[Change of charts.]

We have targeted welfare benefits, with the help of this committee. We have reduced employment in my own Department by about 7 percent, and cut travel some 20 percent.

[Change of charts.]

Our budget for the coming year is $274 billion. As you can see, the biggest part of it goes to social security and HCFA (health care financing), medicare and medicaid.

Ninety-five percent of the money in my Department goes to entitlement programs.

Basically, when you are talking about cutting back, unless you change entitlements you can only shave 5 percent of my budget.

This year's budget is $20 billion higher than last year's budget, and that represents an 8-percent increase in spending. Except for Defense, it is twice the rate of the other Departments—8 versus 4 percent in increasing spending.

[Change of charts.]

This particular chart shows the share of the Federal budget that my Department has. In 1970 it was 25 percent; this year it's 35 percent. The new budget will bring it up to 36.2 percent. Even with reductions in growth—they are not cuts, they are reductions in growth on an absolute basis—my share of the Federal budget will continue to go up. I think that's very significant, considering we are already $56 billion higher than Defense.

[Change of charts.]

Now, this chart shows how drastically they will go up. If you will look at this program chart of spending in my Department, and it is rather typical of social welfare spending throughout the Government since we do the most of it, each decade has seen a sharp increase in spending in social welfare programs—spending was very low in the 1950's, moderate in the 1960's, in the Great Society/New Frontier days, and took off like a jet rocket in the 1970's because of indexing entitlement mandates, and the rise in categorical programs from 150 to 500. Even in the green area under the Reagan administration, unless we change current law the curve will go up even steeper. I think that ought to be a pretty alarming note: that unless we change current law that rise will continue to escalate with the budget going out of sight.

[Change of charts.]

To show how modest our proposals are, in spite of our critics' assessment of them, just changing some $6.8 billion in entitlements, slowdowns which we propose in this budget, we are only making the difference in growth rate between the dotted line and the straight line. Current law is represented by the dotted line. If we change it some $6.8 billion, that will slow the increment of growth a very small amount. It shows you how serious the problem is. Even the littlest change which seems to evoke the greatest outcry is difficult to do. I think it is important to show that these changes have to be made if we are really going to get that growth curve under control.

[Change of charts.]

Now the good news is that we have made some progress, frankly with your help. When I became Secretary of this Department, we were increasing our growth of spending in my Department at a rate of nearly 18 percent. With a $200-plus billion budget, you don't have to be a mathematician to figure out that 18 percent of $200 billion gets to be a pretty big chunk of growth.

With the reconciliation battle, and with the help of this committee, we reduced that 18 percent to 10 percent. Thus, the growth in my Department has shrunk to 10 percent. Our budget proposals this year would further slow it down to 8 percent. But, again, it is still 8-percent growth, still twice that of other Departments, except for Defense. I think there is some indication here that we made some progress in the rate of growth, not the absolute dollars, but that is significant.

[Change of charts.]

In the area of hospital costs, I think we have an extremely serious problem. I know this committee has done a lot of work in this area. Here is a good illustration of it. Hospital costs went up 19 percent this past year, twice as high as the cost of living. It is the worst year in history for hospital inflation. The line here shows the curve.

It is interesting, though, that other medical costs have not done nearly as badly, and we should give some credit to those elements: I think pharmaceutical products were lower than the growth of the cost of living, dental fees were lower than the growth of the cost of living, and even doctor fees only rose slightly compared to the cost of living. But hospital costs were the culprit. Over the last 5 years they have averaged 14-percent increase compared to 10 percent for the CPI. This year it was 19 percent—a totally unacceptable figure to this administration.

[Change of charts.]

Part of the indication of why there is a factor here: my Department pays 40 percent of all the hospital bills in this country. In 1965 we started medicare and medicaid. In 1970 it was about $13 billion; $63 billion the last fiscal year. And this figure of $63 billion will triple in the next decade if we do absolutely nothing about it and leave current law in place, which puts them at a $200 billion rate in a very short period of time. So there is part of our real problem.

[Change of charts.]

I think this shows why costs go up. I think there is a good chart explanation to it. As we all know, the consumer doesn't play much of a role. The doctor orders a service in a hospital, the hospital administration delivers it, and the health insurer pays for it. Obviously the consumer plays virtually no role in that consumer choice decision.

[Change of charts.]

An illustration of this statement, back in 1950 the hospital per diem charge was $15, in 1980 it was $245; it's probably $260 today. If you put it in constant dollars it went from $22 to $99, about 450 percent, eliminating inflation. But the key was that the out-of-pocket costs paid by the patient were 30-percent cost sharing back in 1950; and now they are only 9-percent cost sharing. So the patient's proportion has gone down. And if you put that in constant dollars, the average person only pays $2 more for his hospital bill over that 30-year span even though the hospital bill has gone from $15 to $245. That tells the whole story. Nobody feels the pain out there, so the bill just keeps going up, we keep passing the buck through the system.

[Change of charts.]

Now, we have made some proposals in medicare that have some controversy. We have got to get a handle on this some way. These proposals are a temporary way of dealing with the problem. We have some permanent recommendations, too. And basically the impact will be on the providers and not the beneficiaries in terms of the medicare savings. It is important, to note that hospitals will get 37 percent of the burden; Federal employees, 21 percent of the burden; physicians, 18 percent of the burden; employers and group health plans, 15 percent; beneficiaries, 9 percent; for a total savings of $3 billion. The portion that directly goes to the beneficiary is less than 10 percent, and we have purposely designed it that way. I figure that if a hospital rate is going up 19 percent, somebody ought to be able to swallow something—with a rate that is twice the rate of the cost of living.

[End of charts.]

Mr. Chairman, last year 25 programs of this Department were consolidated into seven block grants, reducing over 300 pages of Federal regulations to 6. The new budget proposes to consolidate additional programs, thereby accelerating the return of decisionmaking to the States and reducing administrative costs.

Inherent in the President's Federalism Initiative, as in the economic recovery plan, is the idea that the time has come for a constructive change, for a sorting out of Federal and State responsibilities, giving new fiscal resources to the States to assume full partnership in addressing the Nation's concerns.

Mr. Chairman, before getting into specifics of some of the key programs I am going to talk about, I would like to take 1 minute to mention our competition initiative. I believe firmly that part of the solution to moderating various health care costs lies in increasing individuals' participation in decisions about their health care and in increasing the opportunities for competitive forces to operate in the health care industry. To that end last spring I established a competition task force within HHS to study proposals to encourage consumers to make more cost-conscious health care choices and to encourage the system to promote diversity while avoiding overregulation in the medical sector.

Recently we sent to the White House a number of options to be considered by the Cabinet Council on Human Resources. Once selected and in final form, I believe we will have some positive mechanisms to improve economic incentives among consumers, insurers, and providers for more cost-effective health care.

The medicare and medicaid proposals differ, in a sense, from proposals to other entitlement areas, because health care entitlements suffer from the explosive growth in the cost of health care services generally. The costs of the medicare program were $35 billion—a 20-percent increase over 1979. In 1982 medicare expenditures are projected to reach a staggering total of $49.6 billion—or a 16-percent increase over last year.

The funding picture with respect to medicaid is also alarming. The Federal share of medicaid payments will soar to nearly $17.8 billion in 1982.

Hospital costs have been the largest driving factor in medicare/medicaid program costs. They have continued to rise at an intolerably high rate—an estimated 19 percent in 1981. Our present cost-based reimbursement continues to contribute to this trend, even as we are trying to reduce inflation to the economy and cut the size of Federal spending.

The medicare hospital insurance trustees now estimate that because of expected inflation in hospital costs, the trust fund will spend $67 billion under current law in 1987—a dramatic 175-percent increase over its 1980 disbursements of just a year or two ago. If medicare is to continue to meet the basic health care needs of the elderly, these trends must be checked.

Our fiscal year 1983 medicare proposals would meet basic health needs yet reform medicare coverage policy and reimbursements to providers as well as streamline program administration. Major savings resulting from these proposals will be derived primarily from sources other than beneficiaries. Our 1983 medicare proposals would hold expenditures next year to approximately $2.5 billion below what they would otherwise be and generally add additional revenue of approximately $600 million.

I might say that even with those changes, medicare will go up $5.8 billion. So it is not that we are cutting back; we are just trying to alleviate the escalation.

The 1983 budget also includes legislation and regulatory initiatives that emphasize control over medicaid costs and improve the efficiency and effectiveness of the program. As you know, we are engaged in discussions with the Governors on the details of the President's federalism initiative, which, if approved by Congress, will mean the Federal Government will assume financial responsibility for the medicaid program beginning in 1984. Absent reforms in the interim, however, medicaid costs will continue on an upward course.

Our proposed reforms include modest cost-sharing requirements for beneficiaries, reduced Federal matching for certain services, and increase emphasis on family responsibility. These proposals are vital if we are to bring about needed reforms in the medicare and medicaid programs.

In developing the 1983 budget, every open-ended entitlement program was closely examined for possible reforms. In the SSI program, we identified a number of relatively minor changes, which are: Relate SSI benefits more closely to an individual's income and circumstances; tighten the eligibility requirements for disability payments; and simplify program administration.

We have also included proposals that will affect the administration of the OASDI program, of social security benefits, as well as the SSI program. These are intended primarily to facilitate program administration and to improve or maintain program integrity without affecting entitlements.

The social services block grant under title XX of the Social Security Act enacted last year was implemented in fiscal year 1982. This program was designed to provide States with greater flexibility in determining priorities among the needs of their population and in allocating resources accordingly.

A level of $1.974 billion is requested for the social services block grant to continue support for the variety of social services authorized by this program. A State may also use a portion of its allocation to support work incentive programs; however, we expect that in fiscal year 1983 as in 1982 the States will be in a position to use the greater latitude in use of these funds to develop more cost efficient and effective social services delivery systems.

As part of this same effort, we are proposing a consolidation of major child welfare authorities under title IV of the Social Security Act: child welfare services and training, foster care and adoption assistance. The authorizing legislation for this block grant is now being developed, and we believe we have created a program which reduces the Federal burden on the States while retaining the essential protections for children in foster care and for those receiving child welfare services.

We are proposing a number of additional changes in the AFDC program which will insure that assistance is provided only to those who are in need and cannot provide for themselves; strong work requirements; and administration of the program is improved.

Several of the other proposals would require that in determining a family's need for AFDC all sources of income available to the family will be considered, including the contribution of individuals who share a household with an AFDC unit. We seek to further reduce the duplication of payments by different programs for the same need and to provide assistance to only those adults which still have substantial family responsibilities in the home.

We propose to eliminate over several years Federal matching for erroneous AFDC and medicaid benefit payments and to establish a consolidated grant to combine and cover State and local costs of administering the AFDC, medicaid, and other food stamp programs.

These are the major aspects of the fiscal year 1983 budget that come under the jurisdiction of the Senate Finance Committee. The important thing overall is that we bring reckless Federal spending under control. The only way to do that is to limit Federal expenditures to those that are necessary, to restructure existing benefits in such a way as to curb abuse, avoid duplication, and streamline administrative expenses.

I will be happy to answer questions that you, Mr. Chairman, or members of the committee may have.

Thank you.

[The prepared statement follows:]

DEPARTMENT OF HEALTH & HUMAN SERVICES
Office of the Secretary
Washington, D.C. 20201

FOR RELEASE ONLY UPON DELIVERY

STATEMENT

BY

RICHARD S. SCHWEIKER

SECRETARY OF HEALTH AND HUMAN SERVICES

BEFORE THE

SENATE FINANCE COMMITTEE

TUESDAY, MARCH 9, 1982.

Mr. Chairman and members of the committee, it is a distinct pleasure to be here today to discuss relevant portions of the President's Budget for Fiscal Year 1983.

The budget we present for fiscal year 1983 builds upon the new course we began last year: it is based on helping those most in need, a new partnership with the states, fiscal responsibility, reform of our entitlement programs and regulatory relief.

We will maintain our leadership role in health research and in disease prevention and control. We will confront the hard facts of health care cost inflation.

Overall, the 1983 budget for Health and Human Services will total $274.2 billion in outlays, an increase of $20 billion or 8 percent over 1982. Our share of the federal budget increased to 36 percent --still more than all 50 states combined -- more than the budget of any nation on earth except the United States and the Soviet Union, and $56 billion more than the Defense budget.

One year ago, the cruel reality of inflation and the harm it was inflicting prompted the American people to demand that their government adopt spending reforms. Today, it is even more imperative that we utilize discipline in federal spending, stemming the rate of growth in HHS programs, thus helping reduce inflation.

The major sources of growth have been in Social Security and the medical entitlement programs, which have risen from negligible levels to the single largest source of budgetary growth in this decade.

Significant progress toward reform was made in the landmark Omnibus Reconciliation Act of 1981, in which the Congress, for the first time, used the full leverage provided by the Budget Act to shepherd significant entitlements changes through to final enactment. Much more, of course, remains to be done.

Throughout his Fiscal Year 1983 Budget, the President is calling for re-examination of our current law eligibility and benefit commitments. These proposals are the result of many months' of work within the Administration -- grappling with the difficult sorting out of valid commitments from invalid ones, and excessive benefits from appropriate ones. This is the challenging task the Congress now faces if these programs are to be brought under control.

Under our proposals, Social Security benefits will continue at current levels with full cost-of-living increases; the budget makes no major recommendations concerning Social Security benefits or financing, pending the report of the National Commission on Social Security Reform.

Head Start's service to disadvantaged children will be continued, as will our emphasis on preventive medicine and health promotion, making "wellness" as pivotal as treating sickness.

Last year, 25 programs of this department were consolidated into seven Block Grants, reducing over 300 pages of federal regulations to six. The new budget proposes to consolidate additional programs, thereby accelerating the return of decisionmaking to the states and reducing administrative costs.

Inherent in the President's Federalism initiative, as in the Economic Recovery Plan, is the idea that the time has come for constructive change, for a "sorting out" of federal and state roles. The reforms of the 1983 Budget are preliminary to a comprehensive program, which will be submitted to the Congress this spring, giving new fiscal resources to the states to assume full partnership in addressing the nation's domestic concerns.

Mr. Chairman, before getting into specifics of the programs that I am here to talk about, I would like to take a minute to mention our competition initiative. I firmly believe that part of the solution to moderating various health care costs lies in increasing individuals' participation in decisions about their health care and in increasing the opportunity for competitive forces to operate in the health care industry. To that end last spring I established a competition task force within HHS to study proposals to encourage consumers to make more cost conscious health care choices and to encourage the system to promote diversity while avoiding overregulation in the medical sector.

Once our competition initiative is completed and implemented I believe we will have some positive mechanisms to improve economic incentives among consumers, insurers and providers for more cost effective health care -- and mechanisms that will permit the powerful influence of consumer choice to foster a healthy balance of competition in the health care market -- a market that has suffered badly from the loss of effective consumer participation.

Medicare and Medicaid

Let me now turn to proposals relating to the Medicare and Medicaid programs. Mr. Chairman, these proposals differ, in a sense, from proposals in other entitlement areas. In addition to the problem of rapidly expanding eligibility, health care entitlements also suffer from the explosive growth in the cost of health care services generally. In the period between 1965 (when Medicare and Medicaid were enacted) and 1980, health care costs rose at the astonishing rate of 12.6% annually, during a time when the inflation rate averaged only 7.7%.

Costs of the Medicare program in 1980 were $35 billion, at 20.2 percent increase over 1979. Medicare expenditures in 1981 were $42.5 billion, a 21.3 percent increase over 1980. In 1982, Medicare expenditures are projected to reach a staggering $49.6 billion, or a 16.6 percent over last year.

The funding picture with respect to Medicaid is also alarming. In 1967, the first full year of implementation, combined State and Federal costs for this program totalled $1.9 billion. By 1982, the Federal share of Medicaid payments will soar to nearly $17.8 billion.

Hospital costs have been the largest factor driving total Medicare/ Medicaid program costs. And these costs have continued to rise at an intolerably high rate -- an estimated 19 percent increase in 1981 alone. Our present cost-based reimbursement system continues to contribute to this trend by paying whatever the hospital bills us, even as we are trying to reduce inflation in the economy and cut the size of Federal spending.

It is important to remember, too, that hospitals are a major recipient of Medicare and Medicaid reimbursements and they rely on this source for their continued existence. Therefore, we believe they must be willing to share in the burden of reducing Federal expenditures in order to guarantee over the long term the financial viability of these programs.

I would like to point out here that the Medicare Hospital Insurance trustees now estimate that because of expected inflation in hospital costs, the Trust Fund will spend $67 billion under current law in 1987 -- a dramatic 175 percent increase over its 1980 disbursements. Expenditures under the hospital insurance program are of critical importance for they comprised 69 percent of all Medicare expenditures in 1981. If Medicare is to continue to meet the basic health care needs of the elderly, these trends must be checked.

Medicare Proposals

Our FY 1983 budget contains a number of proposals which would meet basic health needs yet reform Medicare coverage policy and reimbursement to providers as well as streamline program administration. Major savings resulting from these proposals will be derived primarily through those provisions affecting reimbursement of hospitals and physicians, coordination with other insurance plans, and coverage of Federal employees under Medicare. Our 1983 Medicare proposals would hold expenditures next year to approximately $2.5 billion below what they would otherwise be, and generate additional Federal revenue of approximately $600 million. We have carefully analyzed our proposals in order to minimize any undesirable impact on beneficiaries.

Briefly, major reforms include:

- Bring Federal employees under Medicare Part A. Applying the Hospital Insurance tax to Federal employee wages will result in $1,238 million in additional revenue to the trust fund in fiscal year 1983, and $619 million in net deficit reduction. For the first time, Federal workers would become eligible for Medicare based on their Federal employment.

- Modify Medicare coverage of the working aged. This proposal would result in net Federal savings of $303 million in fiscal year 1983. Employers would be required to offer employees ages 65 to 70 the same health benefit plan offered to younger workers. This would reverse the present situation where Medicare has subsidized employers for much of the cost of providing health benefits to older employees.

  Further, we will propose legislation that would provide the Department with additional discretion regarding the way we contract with Medicare intermediaries and carriers. This reform will allow the selection of a contract arrangement, such as a competitively bid, fixed-price contract, which will produce the most economical results in a variety of circumstances.

- Reimburse Hospitals at 98 percent of reasonable costs. Federal savings from this proposal would equal $688 million in fiscal year 1983. The decrease of 2 percent in reimbursable hospital costs allowed by Medicare would be an interim step pending development of a long-term solution to the very serious problem of rising hospital costs which I mentioned earlier. This approach is similar to the Medicaid cost reductions adopted by the Congress in the Omnibus Budget Reconciliation Act of 1981 and has the same goal --

reducing the rapid rate of increase in Federal health care expenditures.

- Limit the increase in physician payments by holding the Economic Index to 5 percent in 1983. Total savings from this proposal would amount to $37 million in fiscal year 1983. This one-time limit would place on physicians a share of the responsibility for slowing the growth of health care expenditures, at a time of severe constraints on the Federal budget.

- Reimburse inpatient radiology and pathology services at 80 percent of reasonable charges, the same level as all other physicians' services under Medicare. Thus, reimbursment for these speciality services in the same manner as all other physicians' services under Medicare, would result in savings of $160 million in fiscal year 1983.

- Establish targets to reduce unnecessary use of hospital and medical care saving $372 million in FY 1983.

- Institute co-payments for home health services to reduce unncessary use of these services and provides savings of $35 million in FY 1983. Home health services are currently free and unlimited. As a result, the program is growing at an annual rate of almost 30 percent. Modest co-payments would be established to encourage beneficiary cost-consciousness in the use of the service. The co-payment would be 5 percent (about $2.40) for the first 100 visits and 20 percent thereafter.)

- Index the SMI deductible. The current $75 deductible would be indexed to the Consumer Price Index in order to keep its economic value constant. This would produce savings of $65 million in FY 1983.

- Establish Medicare eligibility at the beginning of the first full month after attaining age 65 rather than the beginning of the month in which the birthday occurs. This change would conform Medicare practices to similar changes proposed for other entitlement programs and save $145 million in FY 1983.

In addition to these legislative proposals, we will also undertake a number of administrative initiatives, including the elimination of duplicate Medicare payments for services in outpatient departments--saving $160 million in fiscal year 1983. Physicians providing care in hospital outpatient departments are now paid the same rate by Medicare for services as the physicians would be if the services were performed in their private offices. This is true even though the hospital is often reimbursed separately for overhead costs. We propose, therefore, to refine the application of the Medicare "customary and prevailing charge" screens to reflect more accurately the allowable charges for professional services provided in different locations.

The Administration also proposes to establish objectives for Medicare contractor activities and cooperate with private sector efforts to reduce unnecessary days and other services. At the same time, current provisions which waive provider liability for the cost of unnecessary or uncovered care would be eliminated.

Medicaid Proposals

The Department's 1983 budget also includes several legislative and regulatory initiatives that emphasize control over Medicaid costs and improve the efficiency and effectiveness of the program. As you know, we are engaged in serious discussions with the Governors on the details of the President's Federalism initiative, which, if approved by Congress, will mean that the Federal government will assume financial responsibility for the Medicaid program beginning in 1984. Absent reforms in the interim, however, Medicaid costs will continue on an upward spiral.

Briefly, major proposed reforms include:

- Require cost-sharing by Medicaid recipients. We are proposing legislation which would require a $1 per visit co-payment on the categorically eligible and a $1.50 per visit co-payment on the medically needy for physician, clinic and hospital outpatient department services. Also, a $1 and $2 co-payment per day would be required of the categorically and medically needy, respectively, for inpatient hospital services. A number of States have applied for waivers of current law to allow them to institute co-payment practices. Furthermore, we believe a requirement for modest cost-sharing will make beneficiaries and their physicians more cost conscious in their use of health care services. This initiative would result in Federal savings of $329 million in 1983.

- Lower Federal matching rate for optional services for the categorically eligible and all services for the medically needy by 3 percent. This would provide States with an incentive to target resources on those most in need and on services with the highest priority. Federal savings would be $600 million in 1983.

- Eliminate the Federal matching payments for Medicare B "Buy-in." Resultant Federal savings: $203 million in 1983. The buy-in provides an unnecessary subsidy of almost 90% for Medicare-covered services.

- Eliminate Federal special matching rates that currently apply to family planning and State certification activities. Family planning is the only mandatory service matched at a differential rate, and we believe this special matching payment is no longer warranted. This proposal would also reduce the Federal matching rate for State certification activities from 75 percent to 50 percent. Federal savings for 1983 would be $64 million.

- Family support and liens on property. We will propose regulations to allow States, under their laws of general applicability, to require adult children of institutionalized Medicaid recipients to contribute to the cost of their parents' care. In addition, we will propose legislation which will simplify current State efforts to recover Medicaid costs from recipients' estates when the property is no longer needed as a residence by the recipient, the spouse, or any minor children. These proposals would eliminate an inappropriate public subsidy to beneficiaries' families and heirs, while continuing to assure access to needed care.

- o Establish a policy of phasing in full State responsibility for erroneous payments, saving $59 million in 1983. It is essential that, in this tight fiscal climate, reduced resources not be wasted.
- o Shorten the automatic extension of Medicaid eligibility. Currently, individuals who lose their eligibility for AFDC as the result of increased earnings are granted an automatic Medicaid extension of four months. We propose to reduce the extension to one month, sufficient time for private employment-based health insurance to become effective. This will save $75 million in 1983.

Mr. Chairman, the legislative and administrative proposals I have just discussed are vital if we are to bring about needed reforms in the Medicare and Medicaid programs. The Federal bill for health and medical care should continue to be a priority item for review by both the Administration and the Congress.

SSI and OASDI

Let me now turn to proposals relating to the SSI program and then to some changes that also affect administration of the OASDI system of Social Security.

SSI

In developing the 1983 budget, every open-ended entitlement program was closely examined for possible reforms. In the SSI program, a number of relatively minor changes were identified. These changes fall into three categories:

- Relating SSI benefits more closely to an individual's income and circumstances;
- Tightening the eligibility requirements for disability benefits in the SSI program; and,
- Simplifying program administration.

Included in the first category of relating benefits more closely to need are the following changes:

- A proposal to end for future beneficiaries the special advantage that SSI recipients with other income get as a result of the present provision for disregarding up to $20 a month of any income in the calculation of SSI monthly payments. The present provision helps those with some income other than SSI--not those who are wholly reliant on SSI. The SSI benefits to persons receiving only SSI will not be reduced by this change. Those who now benefit from the exclusion will continue to do so as long as they remain continuously eligible. This proposal will save about $15 million in FY 1983; and

- A proposal to prorate the first month's benefit to reflect the actual date of application or first eligibility (if later). This change will eliminate payments for that part of a month preceding the person's benefit eligibility and application for payments and will save $40 million in FY 1983.

I am presenting two proposals which would help ensure that SSI disability benefits are paid only to recipients who are totally and permanently disabled. They are:

- Changing the definition of disability'' to require that an individual's impairment must be expected to last at least 24 months, rather than the current 12 months. This change will save $45 million in FY 1983; and

- Giving greater consideration to objectively-determined medical factors in determining whether or not an individual is disabled rather than nonmedical factors (such as age, education, and work experience) which are much more subjective and result in inconsistent decisions. This change will save $75 million in FY 1983.

In order to simplify program administration, I offer:

- A proposal to round the maximum monthly SSI payment and actual benefit amount to the next lower dollar. Title II Social Security benefits are already rounded to the next lower dollar under a provision of the Omnibus Budget Reconciliation Act of 1981. SSA is taking administrative steps to assure that final payment amounts--after taking account of individual income--will also be in whole dollars. This proposal will save $20 million in FY 1983.

In addition, I want to present several technical proposals which merit your attention:

- A modification to the provision for retrospective monthly accounting for SSI, which was enacted as part of the Omnibus Budget Reconciliation Act of 1981. That provision has the unintended effect of giving SSI recipients who also receive Social Security benefits an extra increase for the months of July and August as a result of the regular July cost-of-living increases. SSI recipients would not receive the proper payment amount until September.

We propose a modification which will assure smooth coordination of the cost-of-living increases in Social Security and SSI while retaining the overall advantages of the retrospective accounting system. This proposal would restore the projected savings of $20 million in FY 1982 and $40 million in FY 1983.

- We propose a change which would remove an unintended limitation in the applicability of the provision in the Omnibus Budget Reconciliation Act of 1981 which dealt with unnegotiated SSI checks. This amendment would make clear that the procedures of notice by the Department of the Treasury and the follow-up investigation by the Secretary of Health and Human Services apply in the case of all checks issued under the SSI program that remain uncashed for more than 180 days, whether or not State supplementary payments are included in the checks.

- We are proposing a four year phase out of the "hold-harmless" provision. This change affects only Hawaii and Wisconsin and is necessary because, as a result of changes adopted in the late 70's, the "hold-harmless" provision did not phase itself out as a result of increases in the Federal SSI benefit as originally intended. The first stage of this change, affecting the FY 1982 "hold-harmless" amounts, is reflected in the current continuing resolution.

- We are also proposing the elimination of the mandatory pass-through provision. The current pass-through requirement, in effect since July 1977, mandates continuing State fiscal participation in the SSI program. By repealing the pass-through requirement, our proposal would return to the States the basic freedom to decide how much of their revenues would be spent on supplementation programs. Mandatory pass-through restricted that freedom by establishing minimum supplementation and expenditure levels below which the States are not free to go without forfeiting Federal funds under the Medicaid program. By repealing the pass-through requirement, our proposal would return to the States the basic freedom to determine the extent to which they wish to supplement Federal SSI benefits and, as a result, provide them with a greater degree of control over their expenditures.

- Finally, to protect the food stamp cash-out status of California and Wisconsin in light of the foregoing changes, we are modifying the cash-out requirements. States would be permitted to retain cash-out status so long as they agree to provide a supplement equivalent to the value of food stamps that an individual or a couple with only SSI income could receive.

Social Services and Child Welfare

The fiscal year 1983 budget for social services activities continues the effort begun in fiscal year 1982 to increase State flexibility in the programming and administration of program resources and to simplify Federal administrative and oversight responsibilities. The Social Services Block Grant under Title XX of the Social

Security Act, enacted as part of the Omnibus Budget Reconciliation Act of 1981, was implemented in fiscal year 1982. This block grant program was designed to provide States with greatly increased flexibility in determining priorities among the needs of their population and in allocating resources among those priorities. Interim final regulations for this and the other six HHS block grants were published on October 1, 1981.

A level of $1,974,126,000 is requested for the Social Services Block Grant to continue support for a variety of social services at the State level. The amount requested represents approximately 82 percent of the amounts States received in fiscal year 1982. Services which a State may choose to provide may include, but are not limited to: child and adult day care services, protective services, foster care, transportation, family planning, training, information and referral, counseling, delivery of meals, and health support. In addition, a State may use a portion of its allocation to support work incentive programs, including related child care and supportive services.

Since we are less than halfway through fiscal year 1982, the Department does not yet have available specific data on use of the social services block grant funds by the States. We hope to have preliminary data later this spring. However, we expect that in fiscal year 1983, as in fiscal year 1982, the States will be in a position to use the greater latitude in use of these funds to develop more cost efficient and effective social services delivery systems.

As part of this same effort to increase State flexibility in management of social services programs, we are proposing this year the consolidation of the major Federal child welfare authorities under Title IV of the Social Security Act: Child Welfare Services and Training, Foster Care and Adoption Assistance. The proposed authorizing legislation for this block grant is now being developed. The proposal is not yet final, but we believe we have crafted a program which reduces the Federal burden on the States, while at the same time retains the essential protections for children in foster care and for those receiving child welfare services that are embodied in the Adoption Assistance and Child Welfare Act of 1980.

A level of $380,120,000 is requested for the new Child Welfare Block Grant authority. The amount requested represents 82 percent of the comparable fiscal year 1982 level for the activities proposed for consolidation in this appropriation. This request is based on the assumption that Congress will enact the required enabling legislation prior to the enactment of fiscal year 1983 appropriations.

As I noted earlier, we are proposing to allow States to fund work incentive programs, including child care and supportive services, under the Social Services Block Grant, and will be proposing appropriations language to this effect. No funds are proposed for a separate WIN program in fiscal yar 1983. Eligibility changes in the AFDC program enacted in the Omnibus Budget Reconciliation Act of 1981 and proposed in the fiscal year 1983 budget, in particular mandatory community work experience programs, minimize the need for a separate WIN program.

We believe that the overall effect of these changes in the social services programs will be to allow States to maximize resources and administer programs within their jurisdictions to best respond to circumstances and priorities within their States.

AFDC

The Administration is proposing a number of additional changes in the AFDC program, the basic federally-assisted cash assistance program. These are intended to complement the changes adopted last year as part of Omnibus Budget Reconciliation Act and to further ensure that assistance is provided only to those who are in need and who are not in a position to provide for themselves; that strong work requirements exist; and that administration of the program is improved.

Several of our proposals would require that, in determining a family's need for AFDC, all sources of income available to the family will be considered. These proposals would end the practice whereby families exclude members with income from the assistance unit in order to maximize benefits. They would also require States to recognize the contribution of individuals who share a household with an AFDC unit. We seek, also, to further reduce the duplication of payments by different programs for the same need to provide assistance only to those adults who still have substantial family rsponsibilities in the home. We believe that employable adults whose youngest child is 16 are sufficiently free from family responsibilities to no longer require assistance.

There are several other proposals designed to strengthen work requirements and improve the employability of recipients. The administration believes that all able-bodied individuals who request assistance should be involved in some type of work-related activity or job search from the day they apply. We propose to require:

- that all applicants who are able to work and not caring for young children be required to begin a job search as soon as they apply for assistance,
- that those whose search is unsuccessful and who become recipients be required to actively participate in a community work experience program, work supple-

mentation program, or other activity designed to increase their employability through actual work experience, and in continued job search at intervals set by the State, and

- that placement in private sector employment will remain the foremost goal for these individuals.

We envision that States will include greatly expanded employment activities as an important feature of their AFDC programs. To move recipients from welfare dependency to self-sufficiency is a goal universally shared.

We also have 2 proposals aimed at reducing administrative inefficiency. We propose to eliminate over several years Federal matching for all erroneous AFDC benefit payments and to establish a consolidated grant to combine and cover State and local costs of administering the AFDC, Medicaid, and Food Stamp programs at 95 percent of the fiscal year 1982 level. Both of these proposals offer strong incentives for States to tighten administration of these programs. We believe that public acceptance of and support for assistance programs will be enhanced if we can ensure that administrative costs are kept to a minimum, that only eligible individuals receive assistance and that they receive only the amount to which they are entitled.

Child Support Enforcement

The Child Support Enforcement program assists States in enforcing the support obligations of absent parents to their children, locating absent parents, establishing paternity and obtaining child support. These services are provided to AFDC families and are available upon request to families who are not recipients of public assistance in recognition of the cost avoidance or deterrent value of such services. The Federal government presently pays the great preponderance of the administrative costs of the program and provides a wide range of services and technical assistance to the States.

A major legislative initiative will be proposed to restructure the financing of the Child Support Enforcement Program. On a nationwide basis, there is a still untapped potential to increase child support collections. Program effectiveness varies widely from State to State. Costs are often excessive in relation to support collection. The net result is a deficit to be borne by the Federal Government, under current law, of $191 million in fiscal year 1983. Our restructuring proposal will establish a clear focus on performance, and serve as tangible recognition of superior performance.

A related theme of the Child Support Enforcement legislative proposals is flexibility, giving States the opportunity to make priority choices and to apply workable and worthwhile means to enhance performance in the context of their own individual circumstances. One aspect of this approach, for example, will be a legislative proposal to refocus the Child Support Enforcement audit activity to a concern with program efficiency and effectiveness rather than preoccupation with process alone.

Another Child Support Enforcement legislative proposal seeks to change the method by which States recover administrative costs incurred for the provision of services to custodial parents who are not recipients of AFDC. Last year the Congress enacted a provision on this subject as part of the Omnibus Budget Reconciliation Act. By general consensus, the law as it now stands--while well-intentioned--is administratively expensive, cumbersome, and burdensome on the State Child Support Enforcement Programs. In its place, we will propose legislation requiring States to retain a percentage of collections from non-AFDC cases to offset the administrative costs of processing these cases.

In addition to the above, under current law, there are a number of relatively minor statutory restrictions which make the collection of certain child support payments unnecessarily difficult. We are proposing a series of provisions to overcome these restrictions and, in the process, increase State flexibility in the administration of their Child Support programs.

Women, Infants and Children Feeding Program

Finally, the Administration will submit legislation to broaden the recently established Maternal and Child Health Block Grant to include nutrition services for women, infants and children. This broadened and renamed program, "Services for Women, Infants and Children Block Grant" will thus include a full range of health services for women and children. The broadening of the block grant will also assure the coordination of nutrition services with other health services for pregnant or lactating women and their young children. The combination of services provided under this block grant will be more effective in improving health status than any one component only. A Research Triangle Institute evaluation of WIC prepared for USDA reports that "A recurring scene in studies reviewed was the necessity of merging the three program elements -- supplemental food, nutrition education, and adjunctive health care in order to obtain optimal effects from any one of them." Under the new block grant the States will be able to determine the most appropriate mix of such health and health-related services.

This proposal is logical and necessary for several reasons, and here are some of them:

- Nutrition services (NS) have always been a part of State health programs. In most of the States, nutrition services for women, infants and children are organizationally located in the State health agency, and State health directors have general responsibility for NS as one aspect of a broad MCH undertaking.

- State maternal and child health officials have had significant involvement in the development of NS. From the earliest beginnings of such services, State MCH staffs have exercised considerable leadership and assumed most of the responsibility in their development. For example, many MCH directors took the lead in their States, identifying areas of need, recruiting other agencies to participate in NS, developing community support systems, establishing program criteria, and obtaining additional resources. In other words, State health officials have, over the years, tried to integrate NS into their health programs, where it rightfully belongs.

- The same health care personnel provide both MCH and NS services in the States. Physicians, nurses, nutritionists, health aides and related personnel certify eligibility for participation in WIC as a regular part of the services they provide under maternal and child health programs. For example, the public health nurse in the pre-natal clinic, supported by Title V/MCH Block Grant funds, performs a complete health assessment and determines the mother's eligibility for WIC and other services. The nurse also instructs the beneficiaries in the principles of good nutrition as well as other aspects of prenatal education.

- Nutrition services as an important part of both the MCH program and WIC. Nutrition services have always been a key element of maternal and child health programs and historically were first developed under such programs. It makes good administrative sense to avoid needless duplication and overlap by merging the similar services provided by WIC in a new broader Services for Women, Infants and Children Block Grant. MCH funds are used now by State and local health agencies to employ public health nutritionists. These workers provide nutrition consultation to health professionals, dietary counsel to mothers and their families, continuing education in maternal and child nutrition, and community nutrition education efforts.

Despite having identical objectives, the artificial distinctions of separate programs have inhibited them from achieving their objectives. Although HHS and USDA have attempted to coordinate their efforts, there are always inherent tensions when two departments attempt to administer similar programs.

In the 1980 Report to the President by the National Advisory Council on Maternal, Infant and Fetal Nutrition, it was pointed out in Report Recommendation II that duplication of services and problems in jurisdictional coordination diluted the effectiveness of WIC as a categorical program. The report clearly recognized WIC and the Commodity Supplemental Food Program as "adjunct(s) to health care." The report recommended greater ties between WIC and other State health programs due to the logical relationship between them.

It is also worth noting that this report highlights some of the regulatory and cumbersome administrative burdens which have hindered WIC's effectiveness. The conclusion was that allowing greater innovation, responsiveness and flexibility among State program administrators would be of great benefit in making WIC dollars go farther.

Significantly, the block grants are the vehicles which make those goals possible --goals which are difficult to meet under national categorical-grant programs with many federally-established uniform rules and regulations.

Mr. Chairman, these are the major proposals accompanying the Fiscal Year 1983 budget and falling under your Committee's jurisdiction. The important thing overall is that we bring reckless Federal spending under control.

We believe that our nation can no longer tolerate inaction in the crucial area of social policy. Unless significant steps are taken, our nation may soon be hard-pressed to afford even the most rudimentary support for those who are truly dependent on it.

I will be happy to answer questions that you or Members of Committee may have.

The **Chairman**. Under the early-bird rule, we will now start with Senator Heinz. We will allot each Senator 7 minutes on the first round.

Senator Heinz, then Senator Chafee, then the Chairman, Senator Bentsen, Senator Byrd, and Senator Baucus.

Senator **Heinz**. Mr. Chairman, thank you very much.

Mr. Secretary, let's look at AFDC for a minute. The administration, as I understand it, is proposing to mandate a community work experience program for all AFDC recipients. At the same time, the administration, as I understand it, proposes to eliminate the work incentive program, which is aimed at work registration, employment, and training services, as I understand that program. Is that correct?

Secretary **Schweiker**. That is correct.

Senator **Heinz**. Could you explain the rationale for, on the one hand, having the work requirement and, on the other, eliminating the program that helps people find jobs and helps them with job training?

Secretary **Schweiker**. Well, I think the primary reason is because of the President's decision to start a new program, a $1.8 billion job training program in a block grant form, which basically would be directed primarily to the welfare recipient; in other words, the two high priority target areas of the $1.8 billion job training program that the Labor Department proposed is for welfare recipients and teenage youth from disadvantaged areas.

So when I saw that, and when I realized that we are going to put primary emphasis on welfare recipients in that program, I thought it became duplicative. Frankly, if that had not been proposed, I would not have accepted the proposal to eliminate this program.

Senator **Heinz**. In your judgment, is the $1.8 billion program—which it is not in the jurisdiction of this committee; it's in your old committee, Labor and Human Resources—is that adequate to attack both teenage youth unemployment as well as the job training requirements of welfare recipients, in your judgment?

Secretary **Schweiker**. Well, I think it does two things that the other CETA program didn't do, and maybe three things: No. 1 is, the primary target groups are welfare recipients and teenage youth from disadvantaged areas. These are really the two high priority categories; they are not going to try to cover the waterfront.

No. 2, it is clear that because of the fact the emphasis will be on training, we will end up with a very high dollar value on training as opposed to some of the other aspects of the old CETA program. So the fact that under the old program there was some $600 million spent on training, and we propose to spend $1.2 billion on training, which will be a key factor in attacking this problem.

Senator **Heinz**. Well, I wonder if that is anywhere near enough, Mr. Secretary. But let me ask you this: In effect you are mandating a community work experience program to be set up at the State level. How different is that, albeit it would be paid for by the States, under your proposal, from the existing work incentive program?

Secretary **Schweiker**. Well, for one thing——

Senator **Heinz**. You are asking the States to set up a program; we have a Federal program. Is there any real difference between the two programs except who would be running them and who would be paying for them, or are the two programs substantially the same?

Secretary SCHWEIKER. Are you talking now about the $1.8 billion program?

Senator HEINZ. No; I am talking about the community work experience program contrasted with or compared to the existing WIN program.

Secretary SCHWEIKER. Well, I think one of the factors is that CWEP—the community work experience program—would now be a compulsory requirement. The WIN program was limited to the number of job training slots that were funded through the WIN program. This program would not be so limited. And, in addition, "workfare" would place recipients in public service employment working in return for welfare payments.

Senator HEINZ. Mr. Secretary, let's move on to medicaid.

Secretary SCHWEIKER. Let me say, and I want to say this to Senator Bentsen, too, I am not critical of the WIN program; I think we have had good experience with the WIN program. The key factor in my mind was that we came up with another program the President wanted to put into effect which would have been duplicative and would have overlapped with the WIN program. The new program is addressing this problem to the tune of $1.8 billion. So that's where I acquiesced to this proposal.

Senator HEINZ. Mr. Secretary, moving on to the medicaid program, you proposed a 3-percent reduction in a State's matching rate for all services for the medically needy and for optional services for the categorically needy.

Now, as I look at those proposals, what they appear to represent to me is simply a cost shift from the Federal Government to the States. I suspect the elimination of the matching rate for the medicare part B "buy-ins" would have the same cost-shift effect.

On the other hand, at the same time as you are proposing to shift more costs to the States by simply adjusting the Federal match downward by 3 percent, you are proposing that the Federal Government assume all of medicaid in 1984. Those seem to be conflicting proposals. One day we would tell the States to spend more, and the next day we are going to tell them not to spend anything at all—we'll take care of it.

How do you explain that?

Secretary SCHWEIKER. We explain it this way: As you have seen from the charts, our medicare and medicaid programs are the fastest growing programs. We have got to build some element of control into them. We have an incentive here that puts the optional services on a fast track. And we believe, frankly, that the basic services are more important than the optional services.

Some States like California have some 30 optional services that they cover, and New York covers some 29. We don't believe that we can sacrifice the core program for giving some States that extra escalator. All we are doing is eliminating the incentive to fast track the optional services, so that the emphasis can be on the core services and not the optional services.

Senator HEINZ. Mr. Secretary, thank you. My time is completed.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Mr. Secretary, I feel very strongly that any changes in social security—the payments, cost-of-living index, whatever it might be—should only be contemplated in the context of preserving the fund, that is, the social security trust fund itself. We should look only to bolstering its finances and not use social security to help balance the Federal budget.

Now you have stated in your presentation here that the administration will not make any changes in the social security CPI without first hearing from the National Commission that is studying this.

As you know, there has been considerable talk of freezing the social security cost-of-living increases. This suggestion has been made in this committee and elsewhere.

Would you reiterate for me, please, the administration's position that no changes are to take place in the CPI, as far as social security goes, before the Commission has reported—the study group?

Secretary SCHWEIKER. Senator, we appointed a Presidential Commission, which has a tremendously difficult job. Therefore, we are declaring a position of giving them the first crack at recommending social security changes. Our position is to be on hold until the Commission comes forth with any proposal.

Senator CHAFEE. So there would be no proposal to change the CPI until that takes place?

Secretary SCHWEIKER. That is correct.

Senator CHAFEE. Well, I further would like to stress that any changes in the CPI, as concerns social security, should solely be in connection with preserving the integrity of the fund, the issue the Commission is concentrating on, rather than intertwining this issue with the problems of the Federal budget. Whether the Federal budget is in balance or in deficit, it seems to me, has nothing to do with social security.

Secretary SCHWEIKER. Well, I agree with that, Senator. And I think by deferring to the Commission in this respect we accomplish that objective.

Senator CHAFEE. Now, Mr. Secretary, I would like to get to your block grant proposal for maternal and child health and the women's and infants' nutrition programs. At the same time as consolidating them into a block grant, you are reducing it by $350 million.

Now, you have testified, not only here today in connection with the women's and infants' but also in the past on the maternal and child health, that these are very important preventative health programs.

By block granting them, won't we risk setting up competition between two forces to compete for these dollars? After all, that's what a block grant is all about. I am very skeptical whether this is a wise step since one program deals with food and the other deals with an issue of even greater than food.

Secretary SCHWEIKER. Well, Senator, I know from our experience with this committee last year that you and some other members had some concerns, and I believe you very constructively put forth some proposals that I think guaranteed certain things. Let me say, I'm very receptive to that approach, and I think by some of the actions this committee took last year, and some of those, we covered those concerns.

So we have in mind in this area to provide some basic protections. While that wasn't in our initial proposal, we recognize a concern in this committee.

Senator **Chafee**. All right. I will look forward to working with you on those.

Now, you propose, as I understand it, eliminating the utilization review and also the PSRO's. Yet, who will monitor the Federal health expenditures within the hospitals—the bed occupancy, the length of period—if you eliminate both of these? Will we be dependent upon some voluntary group of doctors?

Secretary **Schweiker**. I think there is a misunderstanding about the PSRO picture. All we have said, basically, is that we don't think they should receive direct Federal funding. We have not said, that they cannot participate in the regular provider system and can get reimbursed under medicare and medicaid. There is absolutely nothing to prohibit the ones that are cost-effective, that do a job, and that participate, from getting reimbursements. We pay reimbursements through the provider to hospitals or groups that elect to use PSRO's. So I think there is a great misunderstanding here. All we are saying is that we feel it's wrong to simply do it all from Washington, that if they are cost-effective, if the hospital chooses to utilize them, they can get reimbursed by medicare and medicaid.

It is very important to make that point. I agree with the thrust of what you are saying.

Senator **Chafee**. That is an important point.

Now, let's refer back to one of your charts there that showed the cost reductions anticipated in medicare and how they would be shared. I didn't write down all the figures, but as I recall, the hospitals' was 36 or 37 percent.

The **Chairman**. We can put that chart up.

[Showing of chart.]

Senator **Chafee**. The individual's share is something like 9 percent, and the Federal employees' was something like 17 or 18 percent—21 percent.

Now, to me, that seems an extraordinary portion for the Federal employees to bear of these reductions, when the beneficiaries bear 9 percent and the Federal employees 21 percent. Could somebody explain that?

Secretary **Schweiker**. Well, that simply means that we believe that the Federal employees should pay their fair share of the medicare benefits that they get. Right now they are not paying medicare benefits that they get, and medicare is the primary payer for Federal employees entitled to this coverage. So they are not contributing as much as tax-paying citizens in terms of medicare. All we are saying is that they should be contributing to the hospital insurance fund just like any other wage earner does. That is just a matter of equity, and it is an idea that has been kicked around for some time. If you want to be fair to the taxpayer, I think it is an equity matter.

Senator **Chafee**. Well, but in all fairness, the beneficiary, the individual, is having half of his cost also paid by the employer through social security.

Secretary **Schweiker**. Right.

Senator **Chafee**. So it seems to me you are coming down a little heavy on the Federal employees.

Secretary **Schweiker**. But they are benefitting from taxpayers' money. They are drawing the fund down. You said you wanted to be fair to the fund. We are bypassing and siphoning money off the fund and not putting any money into the fund. One of the drains on the fund is the money going to coverage of Federal employees who don't pay a cent into the fund.

Senator **Chafee**. I see.

Thank you, Mr. Chairman.

The **Chairman**. Just following up on that, what percentage of Federal employees are currently covered by medicare? [Pause.]

It is well over half.

Secretary **Schweiker**. Yes; about 619 out of 1.34 billion. So, over half. I am giving you a rough figure, about half.

The **Chairman**. So the proposal is not without some justification. That is the point I wanted to make.

Secretary **Schweiker**. It certainly isn't

Now maybe there is a fairer way to do it, Mr. Chairman. We are open on what is the fairest way to do it, but with that drawdown coming out of the fund, we ought to do something.

The **Chairman**. Well, we tried last year, as you probably know, and without success. We were told by Senator Stevens and others that they would work out some compromise this year.

I wanted to make certain I understood this, because I never hear it or read it—maybe you ought to buy an ad. Would it be possible for you to buy an ad to tell the other side what your budget is and how little you are cutting, since you never get it expressed in the media? Could you buy an ad and put it in the paper or on television?

Secretary **Schweiker**. I would like to, Mr. Chairman, because I have used this figure. You know, even with the new defense budget, we are spending $56 billion more than the new, highest defense budget. And our rate of growth is still going to be 10 percent this year. And when you put 10 percent on top of a $275 billion budget, it is like a track with a runaway engine going down there in terms of where we are heading.

The **Chairman**. But there is a $274 billion budget, an increase of 8 percent. I bet all I read tomorrow is that you are going to cut the programs that help poor people.

Secretary **Schweiker**. Well, that's what concerns me; because all we get are the raps for the cuts, when in fact my Department hasn't been cut since I've come, it won't be cut when I leave. It's going to grow every year because of entitlements and because of mandates. And I think it is unfortunate that people always play up the cuts and not the tremendous growth that has taken place in my Department.

The **Chairman**. What is going to happen if we don't do anything? That is a possibility this year.

Secretary **Schweiker**. Well, that one chart dramatically shows that if we do nothing spending during the Reagan years will go up at a higher spending rate than during the Carter, Kennedy, Johnson years, because it is out of control.

[Showing of chart.]

Secretary **Schweiker**. And that's the trouble. Unless we really deal with current law—and that green chart there shows it very dramatically—our rate of growth will be greater than the preceding Presidents'. Every President's budget subsequently is becoming worse under this infrastructure that we are building into that system, regardless of all the budget cutting that has been done.

The **Chairman**. But we might have a different way—of cutting than you have suggested, you understand. We might want to place 223 limits, 110 percent on all hospital costs rather than some percentage; but we may not want to do that, either. But we ought to do something, that's the point that I would make.

You are talking about a $7 billion reduction in your budget?

Secretary **Schweiker**. Seven billion dollars, right.

The **Chairman**. Is that about 2 percent or a little over 2 percent?

Secretary **Schweiker**. Two percent.

The **Chairman**. So we are not talking about "massive cuts."

Secretary **Schweiker**. Two percent. And last year we cut the Carter budget 3 percent, and you might have thought the sky had fallen in. In fact my budget still went up $21 billion last year, even though the gross reduction was 3 percent. This year we are proposing a 2-percent reduction.

The **Chairman**. Well, I think it is difficult to portray accurately all of these figures in a short media presentation, so that is probably why they are never presented. But I think it is important to note that this program is out of hand.

We had a slack time in our committee here about a month ago, and I was reading back testimony that some HEW official had made about 10 years ago, where he was predicting with alarm that medicare would cost $9 billion by 1990. What would be the projected cost by 1990? It will be $113 billion, I think.

Secretary **Schweiker**. Well, the quick answer is, if you throw medicare and medicaid together, it is $200 billion—about $195 billion for medicare and medicaid from our cost point of view if we don't change anything.

The **Chairman**. Well, I just want to say I am optimistic. This committee indicated in our report to the Budget Committee that we hope to achieve or exceed the President's numbers. We didn't suggest just how it would be done, but certainly you must keep the pressure on for spending reductions. I am even more encouraged since you are looking at the providers, who escaped with little or no impact last year.

Some of us who fought President Carter's cost-containment proposals were literally shocked when hospital costs jumped 19 percent. Now, there may be justification for it, and I am certain we will have a witness who will tell us why that happened. But we begin to wonder if we did the right thing in trying to put a mandatory cap on that escalation.

Secretary **Schweiker**. I agree, Mr. Chairman, with that point of view very strongly.

The CHAIRMAN. Well, why did they go up so fast? When inflation was coming down, why did hospital costs go up more than physicians' costs and drug costs and everything else?

Secretary SCHWEIKER. Well, I wish I knew; but we are going to move very quickly into the area of prospective reimbursement.

The CHAIRMAN. You can do that without legislation?

Secretary SCHWEIKER. I think we can do some of that through regulation—not all of it, but some of it. And I think it is a very significant, salient way to go, and we are working very hard on that. I have a task force due to report to me shortly, and that will be controversial, too, but it is the only way I know to bring some relief to the situation immediately.

Senator CHAFEE. Well, Mr. Chairman, just let me say we have prospective reimbursement in our State, and it has been very, very successful. It is tough, be it tough negotiations between the State and the providers, but it is a wonderful way to proceed; it is the only sensible way, and it puts some incentive into the system.

This whole system has no incentive for anybody involved to hold down costs, absent prospective reimbursement and some other changes.

The CHAIRMAN. I think the Senator is correct. I just say for the interest of those who are now benefiting from the system—beneficiaries and those who may hope to benefit in the next decade or so—that I think the challenge is rather significant for this committee. If we can agree, and I am not suggesting just what that agreement may be, then we can help stem the tide of unlimited spending.

There is one program that Senator Chafee pointed out that I have an interest in as Chairman of the Nutrition Committee, and that is the WIC program. In my view it is a good program. I was just wondering how long it will survive if we transfer it to your Department. [Laughter.]

I don't mean that you would do anything, but there would be competition, and the WIC program might be the first to go because you are a health and not a food agency.

Secretary SCHWEIKER. Well, Mr. Chairman, I am in a very unusual position. Some recommendations for a change involving programs in my Department, and they were not recommendations that originated in my Department. So I will be a good soldier and handle whatever programs they give me, but these were not originated within our Department.

The CHAIRMAN. So you would not be too disappointed if it didn't happen?

Secretary SCHWEIKER. Well, I am supportive of the administrative position in this area.

The CHAIRMAN. Well, we are, too, up to a point. [Laughter.]

That may be one point that we can agree on.

Now, how soon can we expect to have your competitive proposal? Are you going to present it tomorrow to the Cabinet Committee?

Secretary SCHWEIKER. I am hoping within a matter of weeks. The new federalism initiative delayed competition temporarily, but things are back on track now and we hope to have a decision soon.

The CHAIRMAN. When would they be effective, if in fact we would act—Senator Durenberger probably knows the answer to that question, but I don't—if in fact we would act expeditiously on the competition proposals? When would they be effective?

Secretary **Schweiker**. Well, we would try to put them into effect as soon as Congress passed them; so I guess you would have to give me maybe about 60 days after Congress passed them, because of the regulations involved. We did score that record last year, much to the chagrin of some States. But I think we could do that if we had to.

The **Chairman**. And finally, Senator Chafee mentioned social security. Some of us are on that task force—Senator Moynihan, Senator Heinz, and myself.

There have been two groups of numbers presented; there aren't any proposals yet. But Senator Hollings has numbers and Senator Domenici has numbers, and in each of their packages of numbers they have some freeze on social security, which could be adjusted—it could be a hard freeze or a partial freeze. But it is my understanding that the administration does not want anything done with reference to the COLA's on social security, even if it means lowering deficits and interest rates and helping the economy. [Laughter.]

Secretary **Schweiker**. Well, I have been very careful in talking to Alan Greenspan, the Chairman, about that. I really don't prescribe or limit what they can do in this area, and I think it would be wrong for me to say they should do this or they shouldn't do that. As far as I'm concerned it's an open book at this point.

The **Chairman**. What is it going to cost us this year if we do nothing and we just go ahead with the regular cost-of-living adjustment?

[Pause.]

Secretary **Schweiker**. About $12.2 billion.

The **Chairman**. The dollar cost, not the political cost. [Laughter.]

Secretary **Schweiker**. You can figure, roughly, it is $1½ billion for every percent increase in the cost of living.

The **Chairman**. But what was your total figure?

Secretary **Schweiker**. $12.2 billion.

The **Chairman**. My time has expired. I do think this is an area that, if in fact we are going to have a bipartisan effort, which I hope will be the case, there are some who feel we can't overlook that particular issue this year. And there have been all kinds of proposals suggested—advancing it from July to October, different ways to pick up a few billion dollars in an effort to get the economy moving. But we won't decide that today.

Senator Bentsen.

Senator **Bentsen**. Yes.

Mr. Secretary, obviously we have to cut back on Government spending, and this Senator voted substantially to cut back; but why would you abandon a program that is actually saving the taxpayers money? And that's the case with the work incentive program, to get people off of welfare and into jobs.

Let me cite you the numbers from the Department of Labor, from the administration, and these are numbers that have just been published: It shows the annualized savings in welfare costs, starting back in 1976 at $251 million, increasing to $760 million a year. Now, that's savings to the taxpayer. And to abandon this program of getting people off of welfare rolls and into jobs I think is a serious mistake. To say that you are going to turn that back to the States, and then turn around at the same time and cut the Social Security's block grant package, cut it by a half a billion dollars, what you are really saying is that State by State is going to abandon this program, and certainly the Federal Government is abandoning that program. And I think that's a serious mistake. I think we really ought to be continuing to work to get people off of the welfare rolls and into jobs. I think that's what they want, and that's certainly what the taxpayers want.

Would you comment on it?

Secretary Schweiker. Well, again, Senator, I think it is important to say that if the proposal for a new $1.8 billion job-training program wasn't on the table, I would have strenuously opposed the elimination of this program.

Senator Bentsen. Well, Mr. Secretary, that particular program you are talking about is a 49-percent cut in the training programs of the Government. That is what you are talking about as an alternative to it. And you are talking about a 49-percent cut there and a 22-percent cut in budget authority.

Secretary Schweiker. Well, I think if you look at the actual money spent on training, it will not be a cut, Senator. It will be an increase, because under CETA we had a lot of auxiliary services.

Senator Bentsen. No. That is not my numbers at all.

Secretary Schweiker. Well, I think you will find that they put a lot of auxiliary services into the program, and the actual dollars on training are larger under the $1.8 billion than the program we currently are supporting.

Senator Bentsen. Well, Mr. Secretary, I don't see that. That isn't the way the numbers add up to me. And here you have got a program that is cost effective, and you were stating a while ago how much you supported cost-effective programs. And here is one where the work incentive program is to encourage people to get off welfare and into jobs that last year, with the Department of Labor's figures of this administration, said saved the taxpayers of this country $760 million and put the people into productive employment, encouraged them to go in that direction rather than staying on welfare. And then to abandon that program I think is a serious mistake.

Secretary Schweiker. The figures under the old CETA program, Senator, were $3.4 billion; but only $600 million was spent on training. Under the administration's proposal, we are spending only $1.8 billion, but $1.2 billion will be on training; so that actual training figures are twice as high as the old CETA program. And I will be glad to supply these figures.

Senator Bentsen. Well, I think you have to get beyond the CETA program. You have to talk about vocational education, and you have to talk about other parts of the training program.

Let me hit one more point, because my time is limited and I want to get your response to it. I am deeply concerned about the cuts we are talking about in the adoption proceedings for children and foster care prevention, the question of seeing that children are not lost in the system.

We passed some legislation in 1980 with some assistance for hard-to-place children, and we are talking about a substantial curtailment there. I would like to have your comments on that, because it is a matter of deep concern to me. I think that one productive thing we can do is to help these children find a home. In this day when we are trying to have families that give some direction to small children, I think it is terribly important that we continue to support that program.

Secretary **SCHWEIKER**. Senator, I believe that the committee did express some of these concerns last year, and I ended up agreeing with them. We incorporated some of them in law.

Our proposal that will be forthcoming would recognize the gains made and the suggestions made last year. We would build it on that basis rather than starting from square one. So we would reflect the work that was done here last year to guarantee some of the things that this committee was concerned about in terms of picking up some of the original intent of the law.

Senator **BENTSEN**. Mr. Secretary, let me propose one other problem that we have under the Texas constitution, and that is the fact that we have a constitutional limit on the expenditure for welfare—some $80 million. And that means that when you transfer back to us some of these additional responsibilities that we have to have time to adjust. That means that the legislature which meets every 2 years has to have met, and we have to take action, have a referendum, to make a correction so we could absorb some of these things if that's accomplished. And I would hope that this was given consideration. I would assume that same kind of a problem may exist in some other States.

Secretary **SCHWEIKER**. It does, Senator, and we have tried to be cooperative with States where they legitimately have no legislative session scheduled and can't do it. We have made a number of exceptions on that basis. We will try to continue that policy with whatever new programs we have.

Senator **BENTSEN**. All right.

That completes my question, Mr. Chairman.

The **CHAIRMAN**. Senator Byrd.

Senator **BYRD**. Thank you, Mr. Chairman.

Mr. Secretary, I just wanted to commend you for the emphasis that you are putting on controlling costs in your Department. Very few department heads have come before any committee of the Congress, historically, to point out just how rapidly the costs of a particular department are growing.

You present some very dramatic figures today. You say that the expenditures by your Department alone will be more than the total budgets of all 50 States of the United States. I don't think the average person really realizes that.

You state also that the expenditures of your Department alone are greater than the total amount of money spent by any country in the world except the United States and the Soviet Union. I think you render an important service in making those facts available, and I commend you for it.

Secretary **SCHWEIKER**. Senator, let me just add to that that even in the new budget we will be increasing our spending rate from about two-thirds of a billion dollars a day to three-quarters of a billion dollars a day. So in the new fiscal year proposal we will still be spending three-quarters of a billion dollars a day in my Department. And my Department will then represent 9 percent of the gross national product of this country. One-eleventh of the whole country's GNP will come from my Department.

Senator BYRD. And as I understand it from your figures, the cost of operating your Department—the total expenditures of your Department, I should say—will be 8 percent greater in the new budget than it is in the current budget.

Secretary SCHWEIKER. That is correct.

Senator BYRD. And the current budget is 10 percent more than it was in the previous budget.

Secretary SCHWEIKER. That is correct.

Senator BYRD. And the previous budget was 18 percent more than in the one before that?

Secretary SCHWEIKER. That is correct.

Senator BYRD. So the whole trend has been sharply upward, and there has been no real reduction in expenditures; there has been a reduction in the rate of growth.

Secretary SCHWEIKER. That is correct.

Senator BYRD. And that your feeling is that there needs to be even a sharper reduction in the rate of growth.

Secretary SCHWEIKER. The tragedy is that, even with this administration, our rate of growth curve increases under current law unless we change something.

Now, the Reconciliation Act passed last year was a very important first step; but if we do nothing in that rate of growth it will get worse again.

Senator BYRD. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Secretary, following up on this same line of questioning, I'm a bit curious. What inflation rates have you assumed in that green chart you showed—1970 to 1980? Do you have that off the top of your head?

The other question I am going to ask is: What inflation rates do you assume for 1980 to 1984 on that chart?

Secretary SCHWEIKER. Well, we took actual inflation rates until the last year.

[Showing of chart.]

Senator BAUCUS. Did you average an amount? Or did you take 1980 alone when you drew that line?

[Pause.]

Secretary SCHWEIKER. For which years are you asking?

Senator BAUCUS. 1970 to 1980. That's a straight line. I am just curious—did you take the average rate of inflation?

Secretary SCHWEIKER. We just averaged out.

Senator BAUCUS. And what inflation rates do you assume for 1983 and 1984?

Secretary SCHWEIKER. The CPI?

Senator BAUCUS. The CPI.

Secretary SCHWEIKER. For 1983 it was 6½ percent; for 1984 it was 5.7 percent.

Senator **Baucus**. And even with those assumptions that you are averaging out for those years, you still have a higher rate of growth. Is that right?

Secretary **Schweiker**. That's right.

Now, for 1982 we assumed 9.1.

Senator **Baucus**. All right.

Turning to another chart you had referred to a couple of times, on where fiscal 1983 medicare savings will come from—my question is the degree to which hospitals will not actually bear the brunt of that. That is, won't hospitals, for a practical matter, pass on those cuts to health insurance companies and also to private patients, including some medigap insurance policies? The point I am trying to get at is, as a practical matter, if beneficiaries will receive the greater brunt of the cuts than is indicated on that chart.

[Showing of chart.]

Secretary **Schweiker**. Well, let me say that the 2-percent override there, which is in the hospital chart, is directed for that not to happen. Now, obviously we are going to have to watch it and to look at that aspect of it.

Senator **Baucus**. Well, it doesn't go, I understand, to medicare patients. But still, hospitals can pass on those cuts, obviously, to private insurance companies. They can also pass them on to private patients—nonmedicare patients. Certainly the medigap policies' premiums will be increased as well.

Secretary **Schweiker**. Well, one of the things we are trying to focus in on that I don't think has been focused in on—maybe you saw one of the House committees had a hearing this week and showed that we as medicare payers were paying as high as five times for lab tests under medicare what they were charging regular patients, and the average was twice as much; that we are being taken to the cleaners; that we are in essence being billed twice as much for some things that doctors and other people normally get charged half as much for. That is why I think there is fat in here. I think we can go after it.

Senator **Baucus**. I think there is fat, too. I am just trying to figure out how we cut out the fat rather than transferring costs ultimately back on to beneficiaries and not addressing some of the problems that Senator Chafee addressed.

Secretary **Schweiker**. I think by targeting our bills so that we don't allow them to charge five times what they are charging the doctor next door for the same bill they are charging us 500 percent more. And the average was 200 percent more. That's why.

The **Chairman**. We have got a plan for that on lab fees that would put a cap on it.

Senator **Baucus**. And then turning to physicians, on your chart you say that 18 percent of your savings will come from physicians. Isn't it true, though, that physicians probably will, under these cuts, accept fewer assignments and also pass on again more of their charges to medicare beneficiaries, as an ultimate practical matter? I am just trying to get at what in fact is going to be the additional cost to beneficiaries.

Secretary **Schweiker**. I would have to say, Senator, that certainly that is a concern to us in terms of the acceptance. And we have been studying that aspect to see what other infrastructure we can build into the system to do it.

Now in terms of the actual fee level, for example, the fee changes here we are making would mean a 5-percent fee to a doctor; and so the increase would be $5 instead of $7.8. So we are talking about a 2.8-percent change here. Maybe they will find a way to circumvent it all, but I would hope that they would have some responsible participation in the system, too. That is something we are going to watch.

Senator BAUCUS. The only point I am driving at here is, probably, ultimately the bars on that chart are going to end up sloping the other way; that is, hospitals initially will bear the greater brunt of the cost, but they are going to transfer all of that off to health insurance companies and private patients. And ultimately the beneficiaries are going to see more of the cuts than is shown on that chart. I am just trying to strive at candor here.

Secretary SCHWEIKER. Senator, how do we slow down the cost's growth? Everybody has a criticism of what we propose, but I would sure like to hear how we do control this thing.

Senator BAUCUS. Well, I think some of the proposals Senator Chafee was talking about should be addressed, and you have mentioned those as well.

I have no more questions now, but I do have a series of questions I would like to submit to you, Mr. Secretary, to get at the ultimate cost of these cuts.

Thank you.

[The questions follow:]

Question. Mr. Secretary, your chart entitled, "Where the Fiscal Year 1983 Medicare Savings Will Come From" states that your proposals would achieve a total savings of $2.99 billion. Your press release of February 8 contained this same chart, as well as a Medicare budget summary (see pages 43 and 44) which detail legislative and regulatory initiatives for Medicare which add up to $2.502 billion.

Could you explain why these two figures do not agree?

Could you list each of the Medicare proposals and the parties (e.g., hospitals, beneficiaries) listed in your chart, "Where Fiscal Year 1983 Medicare Savings Will Come From?"

Answer. The $488 million difference between the two charts is the result of a slightly different configuration of Medicare proposals. The chart entitled, "Where the Fiscal Year 1983 Medicare Savings Will Come From" includes a net increase of $619 million in revenues (budget authority) to the Federal budget in Fiscal Year 1983, a result of the proposal to provide Federal workers with coverage under Part A of Medicare. The Medicare budget summary in the press release is expressed in terms of outlay reductions and therefore did not include the $619 million in increased budget authority. In addition, the Medicare budget summary includes $131 million in savings from a variety of administrative proposals, such as the elimination of the utilization review requirement, PSRO's, and funds for State facility reviews, which are not included in the chart.

The following is a list of the proposals in the chart:

Where the fiscal year 1983 medicare savings will come from

	Millions
Hospitals	$1,123
2 percent hospital disallowance	653
Eliminate private room subsidy [1]	54
Single limit for SNF's and HHA's [1]	18
Eliminate waiver of provider liability	10
Utilization review initiative [1]	267

	Millions
Composite rate for renal dialysis [1]	$121
Federal employees: Bring Federal employees under medicare part A	619
Physicians	540
Update fee screens in October instead of July	210
Limit increase in economic index to 5 percent	−35
Eliminate duplicate payment for overhead in outpatient departments [1]	160
Utilization review initiative [1]	63
Composite rate for renal dialysis [1]	9
Hospital-based physicians [1]	63
Employers and group health plans	448
Modify medicare coverage of the working aged	303
Delay initial eligibility date	145
Beneficiaries	260
Index part B deductible to CPI	65
Require minimal coinsurance on home health services	35
Reimburse radiologists and pathologists at 80 percent	160
Total	2,990

[1] Regulatory initiatives.

Question. Could you tell me how much it would cost States to implement your proposal to require cost-sharing by Medicaid recipients?

Answer. We are not certain how much it would cost States to implement our cost-sharing proposal. We expect that States will require providers to establish mechanisms necessary to collect copayments. Since providers already have in place methods of collecting payments from non-Medicaid patients, we do not believe this would represent an undue burden on either providers or States.

Question. Which States have asked your Department for additional authority in recovery of long-term care costs?

Answer. Many States have expressed concern about the costs of long term care services. Consistent with this, States have been generally dissatisfied with the provision in current law prohibiting the imposition of liens on the estates of Medicaid recipients residing in nursing homes. Therefore, although we cannot document which States would like this authority modified, we expect that many States would take advantage of the change, if it's enacted.

A number of States have wanted more authority to require some form of family supplementation of payments for Medicaid recipients in nursing homes. States in the South, such as Tennessee, Alabama and Georgia, which mandated some form of family contribution in the early days of the Medicaid program, could be interested in additional authority to recover long term care costs through family supplementation. Also, the State of Indiana has questioned whether money received pursuant to a State statute making adult children generally responsible for their indigent parents could be counted as a resource in determining Medicaid eligibility. Since the specifics of this regulatory change have not yet been formally proposed, however, we cannot be certain which States will choose to take advantage of it.

The CHAIRMAN. Senator Danforth.

Senator DANFORTH. Mr. Secretary, I am sorry I wasn't here for your presentation. I understand that it was very strong and very informative.

Isn't it fair to say that we are going to continue to have deficits in the neighborhood of $100 billion or more unless we come to grips with the problem of the entitlements?

Secretary SCHWEIKER. Ninety-five percent of the money in my Department is spent in entitlement programs. And my Department has been the fastest-growing segment of the Government. Unless we deal with entitlements, you can't control the Federal budget. And let me say, unless you deal with entitlements you are going to continue to put disproportionate cuts in some of the better categorical programs that have to swallow it. In my Department I see that, we are really hurting some good categorical programs because we don't deal with entitlements.

Senator **Danforth**. Well, for example, before I came here I had the representatives of the University of Missouri Extension Service in my office, and they were very concerned about past cuts as well as future cuts.

But it is true, is it not? that there is a limit to how much more we can do in the appropriated domestic programs.

Secretary **Schweiker**. There is. In fact, one of the things I fought for, quite frankly, in the budget process was to avoid additional cuts in our health categorical programs, many of which come through this committee, over what we cut last year. I felt we reached a limit and that they had taken their fair share, and I fought and appealed, and we persevered. But the point is, that's exactly right; and that's why we have to deal with entitlements.

Senator **Danforth**. And isn't it also true that in approximately the last decade Federal spending for entitlement programs has increased at about 2½ times the cost of living?

Secretary **Schweiker**. In fact in my areas of special fast track programs, it is even greater than that.

Senator **Danforth**. Yes.

Now, when did we begin the procedure of indexing entitlement programs? It is my recollection that these weren't indexed until the early 1970's.

Secretary **Schweiker**. That's right, indexing was enacted in 1972. And if you will look at the chart——[Showing of chart.]

That's exactly when the chart began to take off.

Senator **Danforth**. So until 1972, we had no indexing of these programs. Now we have a situation which has gotten out of control. And now we have a situation where unless and until we come to grips with the entitlement programs there is zero possibility of having a balanced Federal budget. Isn't that a fair statement?

Secretary **Schweiker**. That is correct. And I also want to say that in the social security case, benefits were overadjusted for inflation. Now, that is not true now, but it was true for the first few years that Social Security was indexed and that is part of the reason that entitlement program spending has risen so quickly.

Senator **Danforth**. Mr. Secretary, I just want to make two points to you, two things that I feel very strongly. The first is this: The American people want interest rates brought down; they believe that interest rates are related to the size of the deficit; they want the deficit brought down; and they are willing to see program changes take place if that will bring the deficit down.

I think that if we are going to accomplish that objective it is very important to think broadly and to think in terms that people can understand.

One thing that concerns me is, if our method of trying to control the uncontrollables is so detailed, has so many small little parts to it that nobody can understand what we are trying to do, we lose the kind of consensus and we lose the support which I think people are willing to give us.

I am concerned when I look at your statement and find out, for example, when you say under SSI, "We identified a number of relatively small changes," or again under AFDC, "We are proposing a number of additional changes in the AFDC program," I think that if we are going to bring the American people on board, and they very much want to be on board in my opinion, we have to think broadly, and we have to think in terms that are easily explained and easily understandable. Simplicity, I think, really is a virtue in trying to control the uncontrollables.

The second point that I would like to make is, I think that the American people are willing to go along with broad changes to try to contain the growth of the entitlement programs, provided that they believe that the program is fair; and that the easiest way to lose the national consensus is that people think that it is not fair, that what is happening is not fair to them. For this reason I think that it is very important for the administration not just to look at domestic appropriations and not only entitlements, although I think that is all important; I really think that it is essential to relook at the Defense Department's budget and also to relook at the revenue losses that we legislated last year.

Now, I know that the President doesn't want to do it, but what I am saying to you is, I really think that the American people want interest rates down; they want to control the deficit; they are willing to go along with it; but it takes this kind of broad comprehensive approach if we are going to do the job.

Thank you, Mr. Chairman.

The **CHAIRMAN**. It dropped a half a point yesterday.

Senator **MOYNIHAN**. Not the stock market, Mr. Chairman; the stock market went down 12 points.

The **CHAIRMAN**. Well, we are working on that, too.

Senator **MOYNIHAN**. You are bringing it down very well. [Laughter.]

The **CHAIRMAN**. We are going to give the President the Patco-of-the-year award, the way he has brought down the stock market.

I think Senator Durenberger and Senator Moynihan came in together. I don't know who was seated first. Do you want to go alphabetically?

[Senator Moynihan gestures to Senator Durenberger.]

The **CHAIRMAN**. All right, thank you. Senator Durenberger is before Senator Moynihan.

Senator **DURENBERGER**. Thank you.

Let me pick up, Mr. Secretary, in the direction everybody is headed here. Probably what we have been doing here—and I do apologize for not being here for your opening statement—is helping the chairman put together an advertisement that we can send out to the American people about what it is we are really doing here.

I agree totally with what Jack Danforth just said relative to where the American people are as it relates to what we are doing; and that is, if we would deal with basic policy programmatic change and they could see in the long term that it leads to deficit reduction, they would be supportive. I think six Republicans who are up for reelection on this committee last year reflected that sense of reality when we voted on social security, and it got undone with the help of lots of other folks, particularly over on the House side. So trying to deal realistically with what it is we are proposing becomes a real problem.

You know the work that I put in on New Federalism. I go back to my State now, which stands to benefit the most from a redefinition of the Federal system, and everybody thinks about New Federalism in terms of cutting and capping and blocking and shifting costs off somewhere into the private sector. And I think all of us need to start dealing realistically with some of these budget recommendations. They have nothing to do with holding down the cost of income security, the cost of feeding, clothing, providing health care to the needy. All they do is narrow the budget deficit from our standpoint.

If I took you through one of those charts that has been raised three or four different times, and I won't ask the gentleman to do it again, the fact of the matter is that there is no savings anywhere except in the Federal budget. Everyone of those cost reductions on our part merely shifts the cost of health care, and medicare, medicaid, for example, off somewhere into the private sector. Either the beneficiaries pick up a little bit of it or the doctors pick up a little bit, or the hospitals pick up a whole lot of it. What do they do with it? Because they don't have very substantial profit margins, they shift it off on somebody else—they shift it off on to employers in this country who pay insurance bills; they shift it off on to Blue Cross. The more healthy hospitals just stop seeing medicare and medicaid patients; shift the load back on to somebody who has already got 35-40-50-60 percent of a load. And that, to me, Mr. Secretary, is the problem with approaching policy change at a time when we desperately need it in this country under the guise of cutting budget.

Time magazine had a chart—I don't know whether you agreed with the figures—here a couple of weeks ago in which they compared 1977 spending and 1983 spending. And they indicated that in real dollars AFDC will be decreasing by 50 percent; medicaid increases by only 3 percent; but social security increases 21 percent and medicare 51 percent.

So when we talk entitlements, we have an apples and oranges situation. When we talk about dealing with the needy versus the large category of income security programs for the elderly, one is an apple and one is an orange. It is a very different situation.

But I care particularly, as you know, about the health care side of this. I am very anxious to convert the language from "in a couple of weeks we are going to see something" to some sense of reality in terms of whether it is competition, whether it is capitation in John Heinz' voucher bill—I could ask you if you have looked at the peer review improvement act that several of us introduced a couple of weeks ago. I think you have got to get those things up where they can be seen by people in this country as quickly as possible. Otherwise, you are going to come here in a couple of weeks, or whenever we deal with this budget, and as reflected from the questions around this table you are going to find a whole bunch of us saying no, no, no, no, no to a lot of things and leaving a perception with the American people that we don't really care, that we cop out in election years, and all that sort of thing.

And that's not what we are up to. We, I think, are sensitive to the fact that the American people are saying, "It's about time to change the way you do things and not just pick a few bucks out of here and there."

The hospital association—one of them; I don't know which one—is doing advertising on the subject of cost shifts. They are telling you what is really going on out there.

My own little hometown hospital in St. Cloud, Minn., has already got a shift of $22 a day on a $320 hospital room. These budget proposals takes it up to $55. They have a got a medicare and medicaid population of 35 percent. They can't do it. They can't do it without shifting it. And the employers and the insurers in this country are saying they can't do it, either.

So I don't think you are going to find it easy as it might be to sit here on medicare and medicaid and just chunk out $4.2 billion because it isn't directly affecting anybody; the fact of the matter is it is directly affecting a lot of people, and it is doing nothing to fulfill this very laudable goal that you have in your statement, which is changing the way we deal with the cost-based reimbursement system.

So I just want to say to you, without asking a question, I guess, which is inappropriate, I think those of us on this committee who deal in policy issues more comfortably than we deal in either budget spending or cutting, at least in the 3 years that I have been here, are very anxious to see where the administration is at on some of the proposals that some of us have made, how far they are willing to go, how far you are willing to stick your neck out, whether the President will even start speaking out on these issues, stop talking about increases in medicare and medicaid being due to fraud, waste and abuse, without defining waste. The waste is in a cost-reimbursement system. Start saying that. Don't imply, as you did in that article—and we all saw it in the Post—don't imply that all of the waste in the system is because somebody is billing you 5 times what they have billed somebody else. That's a peanuts part of the whole system.

I urge you, and I know I am speaking to the converted on this subject but I need to use the forum to urge you and others to impress on the President the urgency to speak out on policy reform and not just budget cutting, or it is going to be very, very tough for some of us this year.

Secretary SCHWEIKER. Well, your point, Senator, about competition as a necessary vehicle to change infrastructure is vital, and I certainly strongly concur.

I also think the prospective review aspect falls right into that same category; because, you're right, we will never change the system unless we change the infrastructure.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. Thank you, Mr. Chairman. I would like to pursue the very sensible remarks that Senator Durenberger made.

Mr. Secretary, as you know, just a week ago—Mr. Secretary? Mr. Secretary? Thank you. [Laughter.]

Secretary SCHWEIKER. I can't miss your voice, no matter which way I am looking, Senator. [Laughter.]

Senator MOYNIHAN. A week ago Senator Packwood, the ranking Republican member of this committee, said that the Republican Party has just about written off those women who work for wages in the marketplace. And that's right; that's clear. What I would like to ask you is this——

The CHAIRMAN. What's clear? That he is ranking?

Senator MOYNIHAN. That he is right. He is not here to defend himself. He's right.

Why have you declared war on women who work in the marketplace and have a small supplement to their income from welfare?

Now, sir, in this morning's Washington Post is a report of a study of the University of Chicago Center for Social Policy which says a quarter of the families who receive AFDC payments, which are social security payments, are going to be cut by your proposals. And why are they going to be cut? They are going to be cut because they are working.

Last year you drove through this Congress the cutoff in the $30⅓ incentive system for working. Today, in New York State, a mother working almost full time, making $486 a month, the average monthly wage of working AFDC mothers in New York gets $21 in AFDC payments, a little energy assistance, and some medicaid. By quitting work altogether, under the administration's fiscal year 1983 proposals, she has another $40 a month. Her monthly income goes up $40.

I want to ask you this: You surely can't be doing this as an economy measure; although a lot of your economics end up with similar results. It can't be an economy measure. Are you in fact doing this to drive these poor women back into dependency so you can abuse them more? [Laughter.]

Senator MOYNIHAN. I am serious.

May I ask, sir, were you at the meeting where the story of the orange and the bottle of vodka was used to demonstrate our economic problems?

Secretary SCHWEIKER. No, I wasn't.

Senator MOYNIHAN. Quite seriously, why do you want to make women who are working dependent again? Is it because it fits the image better? Are you doing it because you want to spend more money?

Under your proposal, the family not working in New York would get $288 in more Federal, State, and city outlays than the family whose head continues to work. Now, what can be the economic or policy rationale for this? And I don't mean to be anything but serious.

Twenty years this committee has tried to build work for people driven onto welfare. One child in three born in the United States today will be supported at some time by the AFDC programs. Are they to be brought up in conditions of utter dependency? Or are they to be supported in conditions in which a parent tries to work?

Secretary SCHWEIKER. Are you ready for me? [Laughter.]

Senator MOYNIHAN. Right.

Secretary SCHWEIKER. First of all, let me say that the income disregard was passed by this committee on three separate occasions as a reform, so this committee——

Senator MOYNIHAN. Ending the disregard is a reform?

Secretary **Schweiker** [continuing.] Made a judgment in the last decade to put an income disregard change into effect. So before we just completely roll over the administration with it, we ought to acknowledge that the committee itself initiated three income disregard proposals, Senator, No. 1.

Senator **Moynihan**. For those who don't know, the income disregard is an incentive to work. It allows you to keep, each month, the first $30 of your earnings and a third thereafter. It helps mothers to stay in the work force. Thanks to the administration, it is no longer available after 4 months; it is a sudden death. A mother finds herself deciding "Do I stay on my job, and give my children less, or do I quit my job and give my children more?" What an alternative to give a mother.

Secretary **Schweiker**. No. 2, which you keep ignoring, is that we still take into account under our proposal work or child care expenses. They are still disregarded. We haven't eliminated the work expense disregard; we haven't eliminated the child care disregard. That's still in there.

Senator **Moynihan**. Do you deny that if your proposals go into effect in 24 States of the Union a working mother will be better off quitting her job? Yes or No, Mr. Secretary.

Secretary **Schweiker**. I would like to finish my answer from your other 15 questions, Senator, if I might.

Senator **Moynihan**. Please.

Secretary **Schweiker**. Next is that in terms of our statistics, in terms of our studies, there has not been a significant change which shows your point of view is correct.

For example, up until 1967, when the disregard was enacted, about 14 percent of all welfare mothers worked. And the interesting thing is that after the income disregard were enacted which supposedly was designed to get a higher percentage of welfare mothers working, it has hardly changed at all. So we have gone through almost 8 or 9 years of this supplement idea, and in fact the 14 percent, within a few tenths of 1 percentage point one way or another, has not changed. So the theory on which you are premising your whole question is not fundamentally sound, No. 1.

Senator **Moynihan**. I would not have regarded that as a theory; I would have regarded that as an empirical proposition. The fact of the matter is that, as a proportion of the population, AFDC recipients have gone down. And as a proportion of the budget, AFDC expenditures have gone down through the 1970's. Not greatly, but it is the one area of social security entitlement expenditures which has in fact declined. Your data do not address this, nor do they address the perhaps more relevant point about the work incentive: A constant proportion may be working while on AFDC, but are more women moving from AFDC to work?

Secretary **Schweiker**. No. 2, in fact just the exact opposite has happened. Thirty-three percent of those leaving welfare prior to 1967 left because they were receiving earned income; in other words, because of jobs. Now only 10 percent leave because they are working. So the point is, if anything, it has worked in reverse. Instead of 33 percent leaving for jobs, only 10 percent leave for jobs. It has been a reverse disincentive, Senator; that's exactly why we are proposing changing it. It keeps people on welfare longer and longer and gives less incentive to people to become self-sufficient.

Senator **Moynihan**. I see. It is your view that the income disregard keeps people on welfare. Well, we will pursue that later. I should like to see your data.

But can I ask you: In the Washington Post this morning, the findings of the University of Chicago study are published. Unfortunately the columns got mixed up. It suggests that in 24 States of the Union, my own included, Kansas included, mothers receiving welfare who work today will, if the administration's proposals are enacted, be worse off working and better off if they stop working and become completely dependent.

Now, is it your judgment that this is so? And is it your purpose? If you find that the analysis is accurate, would you be willing to change your proposal?

Secretary **Schweiker**. Well, first of all, we don't agree with the study in view of the figures that we have given out.

Senator **Moynihan**. You don't agree with the study? So we can have a discussion sometime, Mr. Secretary.

Secretary **Schweiker**. No, because our figures show that the same percent of people are working now than before the incentive was put into effect. That's the whole thesis of his argument. He is just saying hypothetically what might happen if people might decide to work or not work. We are saying experience has shown that that doesn't happen at all. In fact, 14 percent of welfare mothers were working before the incentive was enacted, and 14 percent were working afterwards.

Senator **Moynihan**. Could I ask you, Mr. Secretary, have you held this study in your hand? Have you seen this study?

Secretary **Schweiker**. Have what?

Senator **Moynihan**. Have you seen the study? Have you held it in your hand?

Secretary **Schweiker**. No. The studies always get leaked to the Washington Post first. [Laughter.]

Senator **Moynihan**. In this case, I am sorry to say, it was the New York Times first.

Secretary **Schweiker**. They rotate.

Senator **Moynihan**. No, wrong. Spencer Rich says "wrong." The Washington Post got it first. But I have it right here. It has been available since February 25. [Laughter.]

The **Chairman**. They have a rotation plan between those two papers. [Laughter.]

I want to commend the Secretary for answering the question, when given an opportunity. [Laughter.]

Senator Mitchell.

Senator **Mitchell**. Thank you, Mr. Chairman.

Mr. Secretary, I would like to inquire about that portion of your program that proposes that the low-income energy assistance be counted as income in other programs. That is a matter of great concern in my State, and I wonder if you could explain the rationale for that. It seems to me to impose a severe hardship upon people who are already in a difficult circumstance.

Secretary **Schweiker**. I think it is very important, Senator, to make one thing clear, that again the media has not made clear at all, and that is that if a person has a $100 welfare check, and if they get $100 low-income energy assistance check, we are not offsetting $100 for $100. It is very fundamentally misunderstood.

What we are saying is if they are allocated, in a theoretical assumption that $20 or $50 of that total welfare payment will go to fuel, then we only offset it. So if a person gets a $250 welfare check and gets a $100 check to assist in paying heating bills, then they only offset maybe $15 or $20 or $30, whatever is allowed them in the first calculation. We are only trying to eliminate the duplication; there is not a dollar-for-dollar trade-off.

Many people think if they get a $100 heating check, that immediately eliminates the $100 welfare check. Not true. Whatever we figured for heating in their first theoretical calculation—$20 or $30 a month—that is the only part that gets displaced. And we do it because it is a duplication. That's all.

Senator **Mitchell**. Well, the fact that disturbs me, if I understand it, and correct me if I am wrong, the eligibility criteria in the low-income program are not identical to the criteria for all other programs; and that you could have two families receiving energy assistance, one of which might be eligible for some other assistance program, and another which would not be; that what you are doing is that you are having the offset apply to the family which is most in need; that is, that has an eligibility for some other program which might not—am I wrong in that? And, if not, what is the rationale for doing that? It seems to me that this proposal has the effect of imposing the reductions on those families least able to bear it, and permits the full benefit of energy assistance to go to those who, although not in good circumstance, are not as bad off as the others.

Secretary **Schweiker**. I think, honestly, Senator, your premise is wrong. We would only offset a portion that previously had been provided for heating or cooling costs. And in the previous calculation, I think, your assumption would not be true. So that basically we only offset whatever the theoretical calculation was in the first instance.

I realize it is complicated, and that is why it got somewhat misconstrued. But it gets back to the fact that we are not replacing a $100 check with a $100 check, as many people think.

Senator **Mitchell**. No, I understand that. But let me ask the question again and ask you to submit a response in writing, just so it is clear in my mind.

Secretary **Schweiker**. All right.

Senator **Mitchell**. My understanding is that the eligibility criteria for the low-income energy assistance program is not identical or coterminous in every respect with eligibility for other welfare programs. Isn't that true?

Secretary **Schweiker**. That's right.

Senator **Mitchell**. So that you could have two families, both of which are eligible for low-income energy assistance, but only one of which is eligible because its income is the lowest for some other assistance program. Do you follow what I am saying up to now?

Secretary **Schweiker**. I think so.

Senator **Mitchell**. All right.

Now, the effect of your proposal would be that the family that is eligible for low-income assistance but not for any other assistance program is not penalized in any respect and gets the full benefit of the energy assistance program.

The second family, which is in worse economic circumstances than the first, by virtue of that fact is eligible for some other assistance program, gets in effect a reduction in the energy assistance program.

Secretary **Schweiker**. No. I think where we differ, Senator, and what you are saying is not inaccurate, but where we differ is that one family already is getting an edge over the other family, because they already have a calculation in their welfare payment for fuel. So the family that doesn't have that now is getting discriminated against.

So, by our proposal, we are just trying to balance the two, so that the one family that gets it now will have that taken into consideration; the family that doesn't get it now will not get deducted and also have more equity.

Senator **Mitchell**. Well, of course, the point is that we are not talking about two welfare families; we are talking about one which is and one which isn't, but both of which are eligible for low-income assistance.

I guess I won't pursue it, except to say that I think it is a tragic policy that says the way to solve the problem is to bring them both down further.

Secretary **Schweiker**. We are not bringing them both down. We are only bringing the one down that has the duplicate payment, because he got more payment than the other guy.

Senator **Mitchell**. But he got it because his circumstances are so bad that he is eligible for assistance under another program. In other words, what this says is that the lower the level of your income, the greater of the penalty that you suffer with respect to this part of the program.

Secretary **Schweiker**. Well, in fact, Senator, it is very complicated, because the first family that doesn't get it could be a poorer family. It's just that they don't categorically qualify for AFDC, so they could actually be in greater need than the categorically eligible. So it's really an attempt to be fair rather than to discriminate.

Senator **Mitchell**. Well, that might be true if you limited the offset only to AFDC.

Secretary **Schweiker**. We do. That is what I am trying to say. We do.

Senator **Mitchell**. It doesn't apply with respect to food stamps, housing, nothing else?

Secretary **Schweiker**. No. Only AFDC.

Senator **Mitchell**. All right. Then I would appreciate further statement in writing.

[The statement follows:]

RESPONSE TO SENATOR MITCHELL'S REQUEST REGARDING OFFSETTING ENERGY ASSISTANCE PAYMENTS IN THE AFDC PROGRAM

We are proposing that energy assistance benefits be counted against AFDC and Food Stamp benefits to ensure that the neediest receive the most help from these assistance programs. Without the offset, for example, an AFDC household may be receiving more help with its energy costs than a non-AFDC household with similar energy needs. This occurs because the AFDC payment standard already includes a portion for the family's heating or cooling needs. By offsetting benefits to recognize this duplication, we are making these programs more equitable, particularly for families that have low incomes and are not categorically eligible for AFDC.

Perhaps an example can illustrate how the proposal affects non-AFDC households. Suppose that a family with no other income receives a monthly AFDC benefit of $300, of which $20 is intended to meet its energy need. The family also receives a $100 energy assistance payment. The State could offset the AFDC payment by $20 in the month the energy assistance payment is received. Thus, in that month, the family would receive $280 in AFDC benefits and $100 in energy assistance. Compare this to a family which is not categorically eligible for AFDC and which also receives $100 in energy assistance. In the absence of the proposed offset, the AFDC family actually receives $120 to meet its energy needs, while the non-AFDC family receive only $100. Our proposal would resolve this inequity.

Senator MITCHELL. I want to ask you one more question about medicare proposals, and I'm sorry I was not here; I had to be in the Environmental Committee during your proposals.

I watched you on television last week doing an interview in which you talked about the possibility of modifying the hospitalization benefits under medicare by increasing the deductible and eliminating the 60-day limit. My understanding, originally when the budget was submitted, was that was not included in 1983 but would be included in 1984. I would like to ask whether there has been any change in that planning.

Secretary SCHWEIKER. Senator, it isn't in this budget because it is pending before the President right now. The proposal you are referring to would basically ask for a 6-percent copayment on the per diem for the medicare recipient up to a limit of $2,500 with medical and doctor bills. Once it hit $2,500, then a whole catastrophic protection would take over and 60 days, 120 days, 90 days would be no factor. We do it by a dollar catastrophic trigger at $2,500.

Senator MITCHELL. I would like to make a point on that. According to the information submitted to me, 6 percent of all elderly hospitalizations exceed 60 days; 94 percent are for less than 60 days. The consequence of that proposal, if implemented, and I am going to urge and plead with you not to make that proposal, would be that for 94 percent of current elderly persons who are hospitalized this would result in a dramatic increase in the aggregate of their copayment. Now it is $260, and coverage extends for 60 days. In that 94 percent of cases the deductible would increase, under your proposal, to a maximum of $2,500, and that is a dramatic increase. The fact of the matter is, most elderly people simply couldn't afford to pay it.

I will give you just a few statistics of my own State.

The CHAIRMAN. Could you wait until the second round?

Senator MITCHELL. Oh, I'm sorry. I didn't realize my time had expired. I apologize.

The CHAIRMAN. Well, if you could wrap it up, go ahead.

Senator MITCHELL. Well, if I could just make this point, Mr. Secretary, and plead with you not to pursue that.

In my own State, which has a population older than the national average and incomes far below the national average, we have about 140,000 elderly citizens receiving retirement benefits under social security, the average monthly benefit is about $310, and for a very substantial portion of them it is their exclusive source of income.

You are talking about a large number of people with a total income average of $3,600. To increase the deductible for hospitalization to $260, a maximum potential of $2,500 would have an absolutely devastating effect on them.

I know you are concerned about the elderly; I know you are concerned about health care costs. I am just urging you to consider that fact and not present this proposal to the committee.

Secretary SCHWEIKER. Let me just say, Senator, in very quick response: No. 1, anybody under medicaid has catastrophic protection now. If you are poor or can't meet that standard, you will be covered under medicaid. So we are not bumping people off where they won't have a fall-back.

No. 2, the 90-percent figure wouldn't apply, Senator, because you used the 60-day figure. We could trigger people after a week in the hospital if they had a very tedious operation that cost $2,500, and a lot of operations do. So you could get covered under 1 week or 2 weeks in a hospital, depending on what your doctor bills were.

No. 3, the average person stays in about 11 days. A 6-percent bill for 11 days might run to $156. I happen to believe that if you asked the average person would they give $156 of their hospital bill to insuring that for life they had catastrophic protection, I think they would buy it in a minute.

Senator MITCHELL. Well, I can only say to you, Mr. Secretary, maybe——

Secretary SCHWEIKER. Compared to a $30,000, $40,000, $50,000, $100,000 bill. I just think the average person would buy in a minute $156 for a lifetime protection—catastrophic. The poor get that now; the senior citizens don't.

Senator MITCHELL. Maybe the elderly don't understand it; but I can say to you that there is overwhelming fear and apprehension and opposition to this proposal among the elderly.

Secretary SCHWEIKER. Well, it is not understood at this point. I think you are right.

The CHAIRMAN. Mr. Secretary, I need to leave, and I know Senator Heinz needs to leave, and Senator Durenberger has agreed to stay and referee anything that you may get into with Senator Moynihan after we leave. [Laughter.]

Do you like your work? I mean, I just thought I would check. [Laughter.]

Is it better than being in the Senate?

Secretary SCHWEIKER. Well, it is more of a challenge in terms of hearings, being here.

The CHAIRMAN. Well, your meals aren't deductible. That's the difference.

Well, I appreciate your testimony very much. I have a number of questions that I would like to submit in writing. I think there is one area that was just touched on briefly, that is medicare working-aged proposal and the claim that it would result in an increase in private insurance premiums. I would like to submit some questions along that line.

Plus, as I said earlier, I think some of us believe that just by a 2-percent cut you are going to penalize efficient as well as inefficient hospitals. That is an area of concern. We may have some alternatives, but having heard the different views I still believe that there is some general agreement on this committee that we must come to grips with a program that is clearly out of control.

I appreciate your coming, and I will submit my questions in writing.

[Secretary Schweiker's responses to questions from Senator Dole follow:]

1. You mentioned that the decrease of 2 percent in reimburseable hospital costs by medicare is similar to the medicaid reductions adopted by Congress last year.

I believe, however, that there is a very key difference between the proposals. With respect to Medicaid, the States are reduced by 3, 4, and 4½ percent over 3 years, but they are able to earn those amounts back if they hold costs below an established target. This fiscal year the target is 109 percent of fiscal year 1981 expenditures. The target is increased in fiscal years 1983 and 1984 by the medical care component of the CPI.

Under the Administration's 2 percent proposal, all hospitals would be reduced regardless of their relative efficiency. What incentive would a hospital have if it knew that regardless of how it performed, its reimburseable costs would be reduced by 2 percent?

2. Obviously there is going to be considerable resistance in the Congress to a proposal that penalizes all hospitals—the efficient ones as well as the inefficient ones.

If the 2 percent proposal is rejected, do you have any alternative suggestions on how we can come up with the desired savings?

3. Earlier in the year, the Department was floating the idea of extending section 223 limits to total hospital costs for purposes of medicare reimbursement. So far, section 223 has only been applied to the so-called "hotel", or routine services and costs, that is, nursing, food and room costs. It has not been applied to the so-called ancillary services, such as laboratory, X-ray, and pharmacy. Under a section 223 type approach, only the relatively inefficient hospitals would be penalized and even these hospitals could avoid the penalty by bringing their costs in line with comparable hospitals.

Wouldn't it be better to apply a section 223 type limit to total hospital costs, both routine and ancillary, than to penalize all hospitals by some arbitrary reduction in reimbursement such as the 2 percent being proposed by the Administration?

4. The Administration is proposing to repeal the PSRO program as well as all mandatory utilization review requirements. In fact, your budget projects a Medicare/Medicaid savings of $104 million from this action. At the same time you are assuming a savings of $330 million through a new utilization review initiative. Those savings are attributed to giving medicare contractors greater responsibility for the identification and reduction of waste in the use of health care services as well as a new voluntary cost control effort recently announced by a coalition of providers, insurers, business and labor.

I understand, however, that the budget for medicare contractor operations is being reduced, and I know that you are well aware of the failure of the last voluntary effort to control costs. In view of this, how do you see $330 million being saved from your new initiatives?

5. The Administration had indicated in the past through its support of various medicaid proposals an interest in providing the States with maximum flexibility in the design and administration of their medicaid programs. Yet this year you propose to mandate that States impose very specific co-payment amounts on their recipients, even though in the judgment of many States, copayments have been determined to be more trouble than they are worth. Isn't this inconsistent with your earlier position?

Why not merely allow the States to establish their own levels of copayment? The Governors have been seeking just such flexibility.

6. We know that in some cases home health care can delay institutionalization or enable early discharge from a hospital—so it would seem to be in our best interest to encourage appropriate use.

A co-pay starting on the first day, as is being suggested by the Administration, may provide a disincentive to use the service. Would it be better to start a co-pay, perhaps at a somewhat higher rate, after 15 or 20 visits to discourage extended utilization?

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you.

I want to get back to health care and the runaway costs in the health care system and in our health care programs. There is just one question before I go back to that that I want to address, just so I understand the thrust of the administration's AFDC and related proposals.

Is it correct that the administration's position is that a mother with a 6-month-old child who is indigent—a 6-month-old child—must work or lose her AFDC benefits? Is that the administration's position?

Secretary SCHWEIKER. No, that is not our position.

Senator HEINZ. All right. Maybe for the record you can explain—not now, but in writing—why that would not be a valid interpretation of the administration position; because I think a lot of people are drawing the conclusion that all of your proposals are going to result in mothers with small children having to have work or they will lose their AFDC benefits. That would indeed, force them to make a very difficult decision.

[The information follows:]

RESPONSE TO SENATOR HEINZ' QUESTION REGARDING WORK REQUIREMENT FOR MOTHERS OF YOUNG CHILDREN

Single parents with infants are not expected to work. At State option, single recipients whose youngest children are aged 3 to 6 may be required to participate in CWEP as long as child care is available. When children reach school age, parents are normally expected to participate in a variety of work activities and to accept available jobs.

Under our new legislative proposals, States would be allowed to extend this general work requirement to parents with children aged 3 to 6 where child care is available. This will make the participation requirement in all AFDC work programs consistent with the age requirements now allowed under CWEP.

Senator MOYNIHAN. Would the Senator yield for a statement?

I think he meant that mothers would leave work.

Senator HEINZ. Mothers would leave work, yes.

Let me get back to health care. Senator Durenberger, I think, really hit the nail on the head when he said that everything that is proposed here is not cost containment, it is not reform—it is cost shifting. That doesn't save anybody a penny. It looks good in the unified Federal budget, but it looks bad in the unified private sector or State budget.

The way you really make progress is to do what we have done in terms of deregulation of certain kinds of industries. Certainly the airlines and the trucks are having some tough times because the economy is having a tough time, but nobody doubts that you can get a lot more for your money now in terms of freight rates involving motor carriers, and air fares of airline carriers. We are not going to make any progress in health care until this Congress, together with your help, I hope, passes some, if you will, procompetition proposals.

Now, I understand that in the next day or so some very important decisions are going to be made by HHS and the White House on the shape of competition. I understand there is basically agreement on the kind of legislation, S. 1509, that I have introduced, the medicare capitation voucher, medicare—HMO prepaid plan enrollment, call it what you will. There is not much argument that we are all for something in that area. It might be S. 1509, my CHAMP bill; it might be a slightly broader version of it in terms of your approach.

Second, I salute what you have said about prospective payments to hospitals. The sooner we agree on a prospective payment plan, although I recognize there are some problems we will need to discuss with you, the better.

But the real question is: What are we going to do about competition in the health care sector generally? Senator Durenberger's HIRA bill—Health Incentives Reform Act—is a very important milestone that has been introduced, as were our bills, for the past year, year and a half. And the hardest and most politically courageous part of that bill is to put a cap on either the employer or the employees in terms of the containment factor of what will be deductible. I have heard that the administration may be backing away from having either an employer or an employee-based cap.

Now, frankly, if there is no cap on either one, there is little "teeth" to a procompetition approach. It just becomes a giveaway program like our present cost-based reimbursement system is, and you will never succeed in doing what Senator Durenberger and others of us have suggested must be done.

Now, I understand, Mr. Secretary, that you do favor a cap, that you have favored an employer-type cap. Is that correct?

Secretary SCHWEIKER. That is correct.

Senator HEINZ. Would you agree that if there is not some kind of cap, that the proposal will be largely ineffective?

Secretary SCHWEIKER. Well, first let me say, Senator, we are most supportive of your bill and the voucher area. I think that's basically a good bill. Our proposal is similar, and we are quite supportive of that concept.

Senator HEINZ. We will send you S. 1509 just as soon as we get the chairman back from his meeting. Thank you, Mr. Secretary.

Secretary SCHWEIKER. Second, the idea of a tax cap has been the most difficult of the three proposals before us, because there are so many differing points of view on it. We have tried to refine it and target it with a somewhat different version, but we still are considering the tax cap concept, and it is still in the package being considered. I personally think it is a very important part of the package.

Senator DURENBERGER. I would say to my colleagues that the Secretary is trying desperately to get out of here in the next 5 minutes, if that is at all possible. I leave that with you as an advisory note.

Senator Chafee.

Senator CHAFEE. All right. I will make my questions short. I am up next, as I understand the list.

Senator DURENBERGER. Yes, you are.

Senator CHAFEE. Mr. Secretary, the copayments for medicaid recipients of $1 or $2 on in- or out-patient services. What is your thought on whether this charge will discourage individuals from visiting a doctor, either themselves or their children?

Secretary SCHWEIKER. There have been a number of studies.

Senator CHAFEE. The Rand study indicates there will be a disincentive.

Secretary Schweiker. A Virginia study that actually put into effect one on drugs that shows a big factor. I put it this way: It's a question of overutilization, but nobody is going to be kicked out of a hospital because they don't have a dollar. I think it is important to say that. Obviously if somebody doesn't have a dollar they are not going to be denied treatment. So it is going to be a matter of good will and good effort to do this, but we are not going to kick anybody out because they don't have a dollar.

Senator Chafee. All right.

Now, my next question is, you know in my original remarks I deplored the fact that any fiscal incentives seem to exist anywhere in the system.

The other day I remarked to you that I had visited a fiscal intermediary in California which is doing a superb job providing the lowest cost for any processing of a claim—$2.10. All they got for their cost-effectiveness was the pride that they were No. 1. Well, that's wonderful; we are glad they are doing it, but would the number three lowest cost find any pride in advertising it is No. 3, and what incentive is there for that person not to slip back to No. 41?

Nowhere in the system do I find any fiscal incentives or rewards. Are you addressing that or considering it?

Secretary Schweiker. Well, let me say I agree totally with your premise, Senator. You are absolutely right: there are none throughout the whole system, and that's why it is skyrocketing.

So the answer is, we are addressing it. I have a group working on the fiscal intermediary proposal, and believe me that will be a factor; because we have got to build some financial incentive to them to be cost efficient. I really support the concept the Senator has outlined.

Senator Chafee. Well, in conclusion, when are we going to hear from you on these matters? You mentioned you were working on the prospective reimbursement for the fiscal intermediary.

As Senator Durenberger said, we can cheerfully and willingly support these efforts—certainly I can—because that's where the dollars are going to be saved.

Secretary Schweiker. Well, I would guess in this particular case it's on a different track from the competition area. But my guess would be within the next month or two we would certainly have a proposal up to the Congress in this area.

But we are glad to work with the committee now on it. I mean, I don't want to limit it to what we have. I think you have a good idea, and we will work with you on it.

Senator Chafee. All right, fine.

Senator Durenberger. Senator Byrd.

Senator Byrd. Just one question.

Mr. Secretary, you mentioned certain hospital related costs. In regard to those costs, the Government is billed double, on an average, what the private citizen would be billed. What change in the law would be required to prevent that?

[Pause.]

Secretary Schweiker. Would you restate the question, Senator? I am not sure I understand it.

Senator **Byrd**. In your earlier statement you mentioned that certain medicare costs in regard to hospital-related costs——

Secretary **Schweiker**. Oh, were overcharged?

Senator **Byrd**. Where the Government is overcharged on an average of double.

Secretary **Schweiker**. Well, I have directed the HCFA administrator to go back and find out what the state of the present regulation is. I suspect, like a lot of other things around here, it hinges on the way the regulatory proposal is presently published. So, they are under direction to go back and to see if it takes a revision of the reg. It might take a statutory change; I don't know yet.

Senator **Byrd**. But you might be able to do it administratively?

Secretary **Schweiker**. I hope we can, and believe me, if we can't, we will be sending a proposal up to do it.

I am also getting my IG—Inspector General—geared up so that he can go at it, too. I am looking at it both ways.

Senator **Durenberger**. Senator Moynihan.

Senator **Moynihan**. I will be brief, Mr. Chairman, as the Secretary has to go.

Mr. Secretary, I hope you will take us seriously when we ask why are you making changes in the AFDC system which seem to us counter to every proposition that the administration says it subscribes to and counter to what we have tried to do.

March 17, a year ago, you said the policy of the administration was "encouraging individual efforts toward economic independence." You also sent us proposals to put an end to the work incentive that was initiated in 1967, which we call the earned income disregard.

Now, may I say, sir, that to my knowledge there is no reliable evidence as to the difference between the pre-1967 and post-1967 experience of working mothers. I think you will find there is not. May I ask you to send us your best evidence on this? The fact is that during the 1970's, contrary to an awful lot of rhetoric, the AFDC program stabilized and began to decline as a percent of the budget. That may have been the result of some of the reforms.

This committee did propose changes in the income disregard; it never proposed to drop it after 4 months. That was the administration's proposal. That is point one.

And point two, sir, and I don't ask you to answer it now, but you can, here is the University of Chicago Study. Mr. Secretary?

Secretary **Schweiker**. Well, do you want me to answer your first question or last?

Senator **Moynihan**. Well, my first question was would you send us your best understanding? Yes would be an answer, or No would be an answer, or Maybe.

Secretary **Schweiker**. Well, the Senate Finance Committee did propose a 4-month transition rolling period. That was the initial proposal. And that is not too dissimilar from——

Senator **Moynihan**. My question, sir, was could you give us the best evidence of the Department on reasons for leaving the welfare——

Secretary **Schweiker**. We will give you that.

Senator **Moynihan**. I think you will find they are not settled. But maybe they will be, and that would be good to know.

[The information follows:]

INFORMATION REQUESTED BY SENATOR MOYNIHAN REGARDING THE AFDC EXPERIENCE WITH WORKING MOTHERS AND THE UNIVERSITY OF CHICAGO STUDY

Our evaluation of the previous system of disregards as an ineffective work incentive is based in part on research literature. A Study of the Impact of the Income Disregard: Final Report November 1975, Interstudy, found that the costs of the permanent $30-and-one-third disregard were ten times greater than the savings. Frank Levy, in a report in the Journal of Human Resources, Winter 1979 pp. 77–97 titled The Labor Supply of Female Household Heads or AFDC Work Incentives Don't Work Too Well concluded that "for any particular guarantee, a reduction of the marginal tax rate can raise the labor supply of recipients, if at all, only by lowering the labor supply of the population as a whole." Our evaluation is also supported by the trends in employment among AFDC recipients. The data show that both before and after introduction of the $30-and-one-third provision, indeed throughout the 60's and 70's, the percentage of AFDC mothers with earnings was remarkably consistent, about 14 percent. Furthermore, before the $30-and-one-third provision was enacted about one-third of the households who left the rolls did so because of increased earnings, but by 1979 fewer than 10 percent did so. This evidence indicates that rather than encouraging recipients to work their way off the rolls the provision had the opposite effect, serving to maintain AFDC families on the rolls indefinitely without increasing the percentage of AFDC families that worked.

HHS RESPONSE TO UNIVERSITY OF CHICAGO STUDY

The University of Chicago's Center for the Study of Policy recently analyzed the purported impact of last year's AFDC legislation and the potential effects of the Administration's 1983 budget proposals on low income families. The study claims work incentives for low income families will be eliminated, that low income families will become more, not less, dependent on welfare and that projected savings will not materialize. The study is defective in three major ways: (1) It contains some inaccuracies; (2) the figures cited do not support the conclusions; and (3) it makes unexamined philosophical assumptions which cannot be supported.

Although the study deals with both last year's changes and the proposed 1983 changes, with respect to AFDC it deals with the latter only briefly, and, where it does so, erroneously. For example, it claims that energy assistance will be counted dollar-for-dollar against AFDC benefits, whereas the Administration's AFDC proposal is to count energy assistance only to the extent that it duplicates the amounts for heating and cooling that are in the AFDC payment standard. The study also claims that the Administration proposes to remove children from the grant when they reach the age of 16, whereas the Administration proposes to remove only the needs of the caretaker when the youngest child reaches 16. With respect to AFDC, the findings by-and-large go over the same ground as the study the University of Chicago did last year with the main focus again being on the elimination of the $30-and-one-third after four months and the standardization of the work expense disregard.

The main difficulty with the study is that, despite the fact that it presents masses of numbers, the study presents no direct, empirical evidence for the claim that the AFDC provisions have decreased, or will decrease, the work effort of AFDC recipients. Furthermore, analysis of the data that the study uses to arrive at this conclusion shows that, because it uses data from out of their original context, the very relevance of the data to the conclusions is doubtful.

One clear example of this is the claim that some families will actually be worse off financially if they work than if they don't. With respect to AFDC, the main factor giving rise to this "finding" is the study's use of average work expenses from the 1979 AFDC Recipient Characteristics Study. Since that study was conducted prior to the 1981 changes when there were unlimited work expenses that could be deducted from a recipient's countable income, there was no incentive for recipients to economize in their work expenses. In fact there was a positive incentive for recipients to maximize their expenses to stay on the rolls at higher income levels. In most cases, the only mandatory work expenses for low income families are FICA and State and local income taxes, since their Federal income taxes are low to nonexistent. Other expenses such as transportation and clothing are within the control of the individual and, considerable economies can be realized by recipients. Last year's AFDC changes provide the incentive for recipients to do this, and thus, the study's use of earlier data on work expenses does not give a true picture.

A second weakness of the study is that it implicitly assumes throughout, and sometimes even directly asserts, that the previous system of disregards were effective in moving families into independence. Thus the study asserts that last year's provisions "eliminate the incentives to work for families that are trying to earn their way off the rolls" (p. 1). This completely ignores the abundant evidence that the previously permanent $30-and-one-third disregard, which is the main factor in the changes engendered in the study's "benefit reduction rates" by the AFDC changes, had just the opposite effect—it served to maintain AFDC families on the rolls indefinitely, without increasing the percentage of AFDC families that worked. Thus both before and after the introduction of the $30-and-one-third, and indeed throughout the 1960's and 1970's, about 14 percent of AFDC mothers had earnings. Furthermore, in 1967, before the $30-and-one-third was enacted, about one-third of the households who left the roll did so because of increased earnings, but by 1979 less than 10 percent did so. Clearly the reason for this was that the disregard allowed recipients, even with relatively high incomes, to continue to receive AFDC and thus preserved their dependence on the system. This allowed AFDC to become an income supplement program for individuals able to work, rather than a social safety net for those with no other source of income. Thus rather than providing an effective incentive for welfare recipients to "earn their way off the rolls" by making work more attractive than welfare, the permanent $30-and-one-third only served to make the combination of work and welfare more attractive to some individuals than just work alone.

The problem of making work more attractive than welfare suggests a third difficulty with the University of Chicago analysis: except for one page, buried well into the welfare report (p. 23), it ignores the possibility of using work requirements to make welfare less attractive. The only form of work incentive that the study takes seriously is a positive answer to the financial question whether at a particular moment an individual contemplating work will have more, and how much more, money by working than by not working. In so doing, it ignores the insoluble problem of posing the work/welfare issue simply in financial terms. If one rejects work requirements, the only arrangement that will provide a low marginal tax rate for welfare families is either a system that pays extremely low benefits to those who are unable or unwilling to work and thus penalize those in the first category, or a system that allows individuals with such high incomes to continue to receive welfare that a substantial segment of the population would permanently depend on other taxpayers. The only way out of this dilemma is to take work requirements seriously. No system of welfare will work, nor will it be accepted by the American people, which allows an able-bodied individual to calculate and choose: "Will I be better off if I work or if I allow myself and my family to become dependent upon the work of other individuals?" By enforcing current work requirements and by strengthening them, potential able-bodied recipients would not be given the choice of "decid[ing] to become totally dependent upon welfare" (p. 21).

The study briefly suggests that work requirements of this sort are not workable. It suggests that it will be difficult to document if a person quits or loses their job. Actually this decision is routinely made with respect to Unemployment Compensation. Furthermore, able-bodied applicants and recipients can be required to look for work and to participate in community work experience. The study suggests that the latter has been tried and has failed, because the work that would be provided does not usually develop skills that would help the recipient to find other employment. Three points need to be made here. First, any job provides skills, such as good work habits and a work history, which are relevant to finding other jobs. Second, States are already identifying jobs such as school or hospital aides, which clearly provide valuable experience in finding other jobs. Third, with respect to the work incentive issue, the point is not simply that the community work experience jobs should lead directly to private sector jobs, but that the choice of an individual not to work, and instead be supported by the labor of others, should not be an available option. Thus, the study ignores the possibility of reforming welfare by systematic strengthening of work requirements and instead suggests the return to a system which has proven itself to be hopelessly defective.

Senator MOYNIHAN. The second thing is: This is the University of Chicago study that suggests that in 24 States mothers who receive welfare and earn from working average wages for AFDC recipients in that State—the work is not small; it is about 30 hours a week—will be worse off working than if they just go completely cold turkey dependent on welfare.

This study says in effect that the administration is proposing to push people out of the job market, into dependency. You don't have to agree with this, but would you give us your best judgment about why this is wrong, if you think it is? This is a careful study. It was done by Tom Joe, an economist who was brought to Washington by your predecessor, Mr. Robert Finch, former Lieutenant Governor of California under Governor Reagan, and Secretary of HEW under President Nixon. This is his judgment. It may be wrong. But it goes State-by-State, item-by-item.

I really do feel we need a response from you. If you find Joe's study correct, would you modify your proposals? Because as your proposals now read, it seems to me they declare war on working welfare women.

Secretary SCHWEIKER. Well, Senator, where I disagree with you is, there is a fairness issue here that nobody has mentioned—and I heard that word a lot. If a secretary is earning the same amount of money as your welfare recipient, and hasn't been on welfare, they don't get the income supplement; they don't get their car expenses paid; they don't get their union dues paid; they don't get their uniforms, tools, and many other disregards allowed.

So you talk about fairness? You are telling a person who has never been on welfare, that is holding down the same job as the person who has come off welfare, getting the same pay, that it is OK for the Government to pay one and not the other. You are encouraging the person who has never been on welfare to dip down and do the same thing—go on welfare and then come back up, and they get it for life. There is a catch-22 here, Senator. You have an incentive built in now—an inequity—to say the secretary who has never been on welfare, getting the same amount of money, gets all these benefits; but the person who has dipped down into welfare comes up and gets a special privilege. And I think that is an inequity that makes people want to go on welfare.

Senator MOYNIHAN. You really do like to abuse these people, don't you? And the more of them there are, the more you will be able to abuse.

Secretary SCHWEIKER. I like to be fair, Senator. I like to be fair.

Senator MOYNIHAN. Who was talking about a secretary? I was asking you about a study of the University of Chicago. I asked would you study this and let us know what you think.

Secretary SCHWEIKER. I will study it, but I think we ought to be fair. And I think, instead of just waving this study around——

Senator MOYNIHAN. I think we ought to be fair, too. Yes.

Secretary SCHWEIKER. All right. We ought to be fair to the person who is getting the same income as that person who has been on welfare and is getting no benefits from the Government, no payments, and no disregard.

Senator DURENBERGER. I think we have the answer to the question.

Senator Mitchell.

Senator MITCHELL. Mr. Secretary, in the earlier round of questions you stated that the energy assistance would be counted as income only in the AFDC program. And specifically you said it would not be counted as income in the food stamp program.

Now, I want to refer you to the President's budget, which I have now before me. And at page 44 of that budget, here are these words under the heading of proposed change in the food stamp program.

It says, and I quote, "Energy assistance payments will be counted as income in determining household eligibility and benefit level." That is in the President's budget. It will be counted under the food stamp program, making precisely the point that I made in my earlier round of questioning.

Secretary **Schweiker**. First of all, Senator, I think it is important to say that this is not my department, so obviously I am in an area where we are not directly involved.

Senator **Mitchell**. I understand that.

Secretary **Schweiker**. Second, I think your point is correct in terms of the food stamp aspect of it. But, and here is a big "but," they also have the utility element in there, indirectly, of some account. So you can make the honest argument there the same way. But I think your point is correct.

Senator **Mitchell**. I really wish you—and I ask you to do this not now in the heat of the moment, but when you go back—would you have somebody analyze this? I really, honestly feel that the effect is to penalize those at the lowest end of the scale and to permit others who are low enough to receive low-income energy assistance but high enough so they don't qualify for these other programs to get full benefit of the energy assistance. It just seems to me an inequitable circumstance.

And I don't question your good faith or your motives. In fact, I know you to be concerned about this. And that's why I asked you to take a look at it and give us back some kind of an account.

Secretary **Schweiker**. We will, and we will get back to you and try to get the whole picture together that is outside of our Department.

Senator **Mitchell**. Thank you.

Senator **Durenberger**. Mr. Secretary, I need to ask you just one question, whether it is for the record or whether you have the answer. You have been asked about when we can expect legislation from you in a couple of areas. Is it possible for you now to give us an estimate of when we would get legislation on all of the areas we have to deal with? Welfare, child welfare services, SSI, medicare, medicaid, and so forth?

Secretary **Schweiker**. In terms of all the areas that are up for consideration?

Senator **Durenberger**. Right.

Secretary **Schweiker**. I will put it this way: We are way ahead of last year, thank goodness. And I would guess that there are either on my immediate desk in terms of action or at OMB now—so it is a 10-day turnaround once they get to OMB—I would guess that half of the material should be available shortly to the committee. And the other half ought to be available in about 2 weeks, maybe 3 weeks.

Senator **Durenberger**. Thank you very much, Mr. Secretary.

Senator **Moynihan**. Mr. Chairman, could I submit two questions for the record to Secretary Schweiker?

Senator **Durenberger**. Yes, Senator Moynihan.

[The questions follow:]

Question. How will the revised nursing home regulations, which relax or eliminate current safeguards, adequately protect the health, safety, and rights of nursing home residents, especially in light of reduced federal funding for inspections of nursing homes?

Answer. After a careful review of existing regulations, Secretary Schweiker announced on March 21 that he had decided against making any changes in current health and safety rules (conditions of participation) governing the nation's nursing homes. A copy of the press release announcing this decision is provided for the record.

[Press release—U.S. Department of Health and Human Services, Mar. 21, 1982]

HHS Secretary Richard S. Schweiker today decided against making any changes in current health and safety rules (conditions of participation) governing the nation's nursing homes. His action reaffirms support for a strong federal role in the area of health, safety and patient rights.

After a careful review of existing regulations, the Secretary stated, "Contrary to recent reports in the press, I will not imperil senior citizens in nursing homes, our most vulnerable population, by removing essential federal protections. I will not eliminate any staffing requirements for nursing homes such as medical directors, dietitians, social workers, and other necessary health and safety consultants. In addition, standards for infection control, communicable disease, and drug administration will not be altered.

"The current rules have brought about significant improvements in the long-term care of nursing home residents. The existing health and safety requirements will remain untouched. I will not turn back the clock."

The Secretary's announcement came after an exhaustive review undertaken as part of the Administration's effort to review regulations for their necessity. The Secretary said that "while I recognize the burden placed on nursing home administrators, I also recognize that the federal government must not abrogate a most critical commitment to the nation's elderly."

In addition to the Secretary's decision not to change present health and safety regulations, he also announced that he will soon publish in the Federal Register a proposal to improve nursing home inspections. More inspections will be targeted on substandard nursing homes.

The Secretary said that "The health and safety standards are effective if properly enforced. Our efforts will focus on those facilities that have been identified as not meeting current standards." The Secretary said, "We will inspect those facilities more often than in the past and as often as is necessary to bring them up to standards."

New inspection policies will permit those facilities that have a record of sustained good performance to be surveyed less frequently. The Secretary said "Moreover all facilities will be subject to random inspections based on sampling not unlike what the IRS requires for taxpayer audits. Under this policy change the number and quality of inspections will not be reduced—rather our resources will be redirected to meet the health and safety needs of the elderly."

The Secretary's decision on the new inspection policy is based upon recommendations made by Dr. Carolyne K. Davis, Administrator of HHS' Health Care Financing Administration.

There are about 18,000 long-term care facilities which participate in the Medicare and Medicaid programs. About 1.3 million of their 2.2 million patients are covered under the federal programs. Medicaid pays for about half of all private and public spending on long-term care. The current health and safety standards (called Conditions of Participation) have been in effect since 1974.

RESPONSE FOR SENATOR MOYNIHAN

Question. The Administration proposes consolidating the Social Security and Railroad Retirement systems, and speeding up the financial interchange between the two systems. Apparently, speeding up the interchange will result in a one-time $1.7 billion cost to Social Security. Is there any reason why we should do this when it will cost the system nearly $2 billion?

Response. The primary purpose of the Administration's proposal is to defederalize the Railroad Retirement System (RRS). Under current law, the two systems are closely coordinated financially and administratively. The Administration's proposal would eliminate the financial interchange and the duplication of administrative activities; individuals would receive Social Security benefits directly from the Social Security Administration and railroad pension benefits from a new private corporation chartered by the Federal Government to administer the rail industry pension system.

The Administration's proposal would advance the date of the interchange payment 8 months, to September 30, 1982, instead of June 1, 1983. As a result, almost $2 billion will be paid from the Social Security Trust Funds in fiscal year 1982 that under current law would not be expended until fiscal year 1983. This expenditure should not be characterized as a "cost" because it does not represent any additional liability for the Social Security Trust Funds. It is the approximate net amount of indebtedness to the RRS that the Railroad Retirement Board estimates the Social Security Trust Funds will incur for fiscal year 1982 under current law.

QUESTIONS FOR THE RECORD FROM SENATOR MOYNIHAN, FROM SECRETARY SCHWEIKER'S TESTIMONY TO SENATE FINANCE COMMITTEE, MARCH 9, 1982

CHILD WELFARE BLOCK GRANT

Question. In your response to Ways and Means Committee questions, you stated that the draft Child Welfare Block Grant legislation would be available to Congress in mid-March. Can you tell us what reduction in services or assistance would take place if the funding were reduced as proposed? How many and which individuals would be affected? Which of the protections mandated by the 1980 Child Welfare and Adoption Assistance Act would be maintained?

Answer. The Administration's Child Welfare Block Grant proposal is in the final stages of development, and will be submitted to the Congress in the very near future. The proposed budget level for this Block Grant will be $380,120,000 for fiscal year 1983 for funds to the States for foster care maintenance and adoption assistance payments, child welfare services, and child welfare services training.

We cannot provide figures on changes in services and individuals served under the Block Grant. Because the legislation will give States greater flexibility in deciding priorities and allocating resources in response to those priorities, we cannot, at this time, anticipate how States will respond.

While the proposal is not yet final, as currently drafted, the legislation would require States to maintain the protections that are currently in the 1980 statute, and would contain a provision to set aside funds specifically for the purpose of implementing these protections.

RESPONSE TO SENATOR MOYNIHAN'S QUESTION

Question. The Administration proposes to reduce the "error rate tolerance" so that the federal government does not fund AFDC, food stamp or Medicaid payments made erroneously. Under current law, the federal government does not match payments in error above a 4 percent rate. Under the proposal, the error rate tolerance would drop to 3 percent in fiscal year 1983, 2 percent in fiscal year 1984, 1 percent in fiscal year 1985 and 0 in fiscal year 1986.

It is both empirically and intuitively true that a state's error rate rises as it becomes more sophisticated about catching and labelling errors and as the size of its caseload increases. The more people who receive benefits, and the people involved in processing those applications, the more chances there are for errors to be made. Will the Administration's proposals take these facts into account?

Answer. We would draw a distinction between the State's front line administration of the program and the back-up monitoring of the Quality Control system. It is true that as States become more sophisticated in the operation of the program through error prone profiles, computer matches, and other techniques, more errors are identified. States are also able to correct more errors as well and usually more efficient. The result is to make less and not more error cases in the caseload for Quality Control to find. The administration will continue to focus attention on those front line systems. The accommodation made to workload and training problems is that of phasing in error reduction over a three year period rather than establishing a zero error rate in fiscal year 1983.

RESPONSE FOR SENATOR BOREN

Mr. Secretary, I have been contacted by many Oklahomans about the unintended impact of last year's reconciliation bill relating to the social security benefits. As you know, these benefits will not be paid to anyone not enrolled in post-secondary school by May of this year. The intent of this provision was, of course, to grandfather in last year's high school seniors who might begin college this spring. The unintended effect of the May deadline, however, has been to encourage this year's high school seniors to drop out of school prematurely and enroll in college so as to meet the May deadline. In order to alleviate this problem, Senator Levin of Michigan has introduced S. 2107, which delays the deadline until October. What is the opinion of the Administration regarding Senator Levin's bill? Does the Administration have an alternative which might better address this issue?

Response. The Reagan Administration proposed phasing out Social Security student's benefits because other educational aid programs have been established to assist needy students and because eliminating less essential elements of the Social Security program would help restore the fiscal soundness of the Social Security system. The Ford and Carter Administrations also had recommended eliminating Social Security student benefits for the same reasons. We continue to believe that these reasons for phasing out the student benefits program are sound.

Phasing out student benefits will improve the financial condition of Social Security considerably, saving $10 billion in calendar years 1982–86. Despite this reduction in costs, the Old-Age and Survivor Insurance Trust Fund (which pays retirement and survivors benefits, including most student benefits) is in serious financial difficulty. Under all reasonable economic assumptions, the fund is expected to be unable to pay benefits on time beginning July 1983. Further corrective legislative action must be taken to ensure that Social Security will be able to meet its benefit obligations. S. 2107 would add a significant cost to the trust funds at a time when their status is already extremely precarious.

Any date that might have been chosen for beginning the phase-out would require rethinking by some students of how they will pay for their post-secondary education costs. Delaying the enrollment date cutoff for the phase-out at this point would add to Social Security costs and create confusion without appreciably easing the adjustment to the phase-out of student's benefits.

DEPARTMENT OF HEALTH AND HUMAN SERVICES,
OFFICE OF THE SECRETARY,
Washington, D.C., May 7, 1982.

Hon. WILLIAM V. ROTH, Jr.,
U.S. Senate,
Washington, D.C.

DEAR SENATOR ROTH: On behalf of the Secretary, I am pleased to provide you with responses to the questions in your March 15 letter on the Department's 1983 budget. These responses have been forwarded also to Committee staff for inclusion in the record of the March 9 hearing by the Senate Finance Committee.

Sincerely,

THOMAS R. DONNELLY, Jr.,
Assistant Secretary for Legislation.

Enclosures.

Question 1. Won't a 2 percent across the board reduction in hospital reimbursement penalize the efficient hospital more than the non-efficient one? How could this 2 percent reduction proposal be changed to reward efficient hospitals?

Answer. We considered a number of proposals for accomplishing the necessary program savings. The advantages of the proposal to reimburse hospitals at 98 percent of reasonable cost are that it spreads the responsibility for program savings evenly across all providers and is both simple to understand and to administer. This is an interim proposal. Our strategy is to develop and implement as quickly as possible a prospective payment system with its built in incentives for efficiency and cost control. Once such a prospective payment system is in place, efficient hospitals will be rewarded.

Question 2. If you require States to provide Community Work Experience and to document a job search for AFDC recipients at the same time that you eliminate funding for WIN (which funds this type of activity), cut funds in the Social Service block grant (which would become eligible to fund the activity), and cap State AFDC administrative expenses, how will this "workfare" program be supported?

Answer. Money will be available because of program savings due to the closure of an estimated 100,000 cases resulting from proposed legislation, and diversion of 150,000 applicant cases under mandatory job search requirements. Related administrative savings will be commensurate with the program savings.

Money for work activities will also be available because of administrative savings due to the elimination of separate bookkeeping and reporting requirements under the combined welfare administration block grant as well as other improvements in administration.

On-the-job supervision for participants can usually be provided using existing staff at the work site where the recipient is assigned.

Question 3. What assumption were used to develop the savings estimates for the proposals to recover long term care costs?

Answer. Legislative proposal to permit States to impose liens on the property (including homes) of Medicaid recipients residing in long term care facilities—In calculating fiscal year 1983 savings of $183 million, we assumed that States representing three quarters of Medicaid nursing home expenditures would implement this option aggressively and realize 80 percent of potentially recoverable amounts. The 1977 National Nursing Home Survey was used to estimate the number of dead discharges without spouses (approximately 167,000 in fiscal year 1983 assuming an annual growth of 2 percent per year). We assumed these recipients had length of stay patterns which paralleled all nursing home patients. We also expect that recoveries would accrue from persons discharged to private or semi-private residences (65,000 in fiscal year 1983) and, therefore, included this group in calculating savings. To determine assets, we assumed that home ownership patterns among Medicaid nursing home recipients were equivalent ot the general nonmarried elderly population as specified in the 1976 Retirement History Survey and that home equity equals $20,000 in fiscal year 1983 dollars.

Regulatory proposal to allow States, under certain circumstances, to require adult children to contribute to the long term care of their indigent parents—In calculating fiscal year 1983 savings of $29 million, we assumed that States accounting for half the Medicaid nursing home expenditures would aggressively enforce this provision. These States would mandate that families with annual incomes above $15,000 would be expected to contribute. The 1976 Survey of Institutionalized Persons shows that there are almost 900,000 institutionalized Medicaid recipients on any given day and 16.5 percent of these recipients had one or more adult children with incomes above $15,000 in 1983 dollars. We also assumed States opting to implement this provision would mandate contributions ranging from 2.5 percent to 4.25 percent of gross family income. Finally, the anticipated savings were reduced by $75 million which we expect States to incur in administering this provision.

Question 4. The budget projects additional revenue of $619 million by covering federal employees with Medicare, and requiring employees to pay in to the Hospital Insurance trust fund. What estimate do you have of offsetting expenditures? What percentage of retired federal workers already get Medicare by virtue of limited private sector employment or as a spouse?

Answer. Our proposal would require Federal employees to pay the hospital insurance tax beginning in 1983, and would entitle them to Medicare hospital insurance benefits after they turn 65.

We believe that there will be relatively small offsetting expenditures in the first years after enactment of our proposal. We estimate that between 60 and 80 percent of Federal employees currently qualify for hospital insurance based on their own non-Federal employment or that of a spouse.

All Federal employees will be eligible for Medicare. We expect to have a transitional provision to permit Federal employees nearing retirement age to quality for Medicare with fewer than 40 quarters of coverage.

We are not proposing changing the law concerning former Federal employees who have already retired. We have no estimates on the cost of covering these people, but expect that it would be very costly.

Senator **Durenberger**. Thank you very much, Mr. Secretary. We appreciate your candor.

Senator **Moynihan**. Thank you, Mr. Secretary.

Secretary **Schweiker**. Thank you.

[Whereupon, at 12:14 p.m., the hearing was concluded.]

ADMINISTRATION'S FISCAL YEAR 1983 BUDGET PROPOSAL

WEDNESDAY, MARCH 10, 1982

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 2221, Dirksen Senate Office Building, Hon. Robert Dole (chairman) presiding.

Present: Senators Dole, Roth, Danforth, Heinz, Symms, Long, Byrd, Bentsen, Moynihan, Baucus, Boren, Bradley, and Mitchell.

[The prepared statement of Senator Dole and opening remarks of Senator Bentsen follow:]

STATEMENT OF SENATOR DOLE

As we continue our review of the administration's budget proposals for fiscal year 1983, we are pleased to welcome this morning Budget Director David Stockman. I hope the members will take this opportunity to further explore the options contained in the President's budget and suggest alternatives for cutting spending. The time is getting closer when we are going to have to make decisions, and none of them will be easy.

Before we begin I would like to take a moment to comment on a matter that is of some concern to me. Over the past few weeks we have been inundated with budget alternatives, and hopefully we are beginning to learn to sort the wheat from the chaff. Our job is to work with the President to enact a responsible and realistic budget package to carry over the next few years.

At the same time, we have to limit our options, or we will never reach agreement. Some alternatives have to be rejected, and some lines drawn. The President has not hesitated to do that.

This past weekend I was disturbed by reports that Secretary Regan had suggested that the administration might be willing to trade away the tax indexing provision of the 1981 Tax Act. Some of us believe that is the most significant tax change for working people in decades, and that its retention will aid, not hinder, deficit reduction efforts.

The President has recited the virtues of tax indexing many times. Last July 27, in urging the American people to press Congress for passage of his tax bill, President Reagan stressed the dramatic difference indexing made for the American taxpayer. I cannot say it better than the President:

"But then to ensure the tax cut is permanent, we call for indexing the tax rates in 1985, which means adjusting them for inflation. As it is now, if you get a cost-of-living raise that's intended to keep you even with inflation, you find that the increase in the number of dollars you get may very likely move you into a higher tax bracket and you wind up poorer than you would. This is called bracket creep.

"Bracket creep is an insidious tax. Let me give you an example. If you earned $10,000 a year in 1972, by 1980 you had to earn $19,700 just to stay even with inflation. But that's before taxes. Come April 15th, you'll find your tax rates have increased 30 percent. Now, if you've been wondering why you don't seem as well-off as you were a few years back, it's because government makes a profit on inflation. It gets an automatic tax increase without having to vote on it. We intend to stop that."

The President went on to point out that a 25 percent tax reduction was needed in part because bracket creep, combined with scheduled payroll tax increases scheduled over the next few years, would raise taxes by 22 percent between 1981 and 1984. Most dramatically of all, President Reagan produced a chart showing the difference indexing made for the administration bill. As he said, "The green column is our bipartisan bill which wipes out the tax increase and gives you an on-going cut."

PRESIDENT STANDS FIRM

I believe President Reagan has not retreated one inch from his commitment to preventing future bracket creep. In his State of the Union address on January 26, the President stressed the fact that "because we indexed future taxes to the rate of inflation, we took away Government's built-in profit on inflation and its hidden incentive to grow larger at the expense of American workers."

The President's position is clear. But I understand, as we all do, that the President may have to compromise on some tax measures at some point if we want to put together a deficit-reduction package that will help us fulfill our shared economic goals. I was disturbed by Secretary Regan's comments this weekend, however, because I fear that tampering with indexing is precisely the wrong way to go. Bargaining away tax indexing would send the wrong signal to the financial community and to the American people.

OUR BEST JUDGMENT

I know that Secretary Regan is trying, as we all are, to find the best set of alternatives we can agree on. For more than a year now I have had the pleasure of working with the Secretary, and I have the greatest regard for him. But all of us are obliged to exercise our best judgment as to how we ought to proceed, and I do differ with the Secretary on this matter.

The key to this issue is contained in the remarks President Reagan made last July. The President said that tax indexing denies the government a profit from inflation, and prevents automatic tax increases not voted by Congress. That is why it is so crucial at this time to maintain our commitment to honesty in taxation. To do otherwise would send a signal that we were willing to inflate the economy to boost revenues in order to ease our budget crisis. We foreswore that route last year, and it was the most far-reaching change we made.

We can raise revenues without resorting to bracket creep—we can muster the courage to vote for higher taxes when those are clearly needed for the economy as a whole. That is our obligation, as the President has acknowledged by proposing over $30 billion in revenue increases over the next two years. But if we backtrack on the issue of the inflation tax increase, we risk unravelling the progress toward a lower-tax, lower-spending economy that the President has worked so hard to achieve.

BARGAINING ROOM

I know that Secretary Regan offered his comments on tax indexing as part of a wide-ranging interview on tax, budget, and economic matters. It is clear from the thrust of his remarks that the Secretary was primarily aiming at the notion that any revenues must be raised only for purposes of reducing the deficit. As Secretary Regan said, "we're awfully afraid that when you get into tax increases, including dropping indexing, it would only be an excuse to say, 'well, we don't have to cut anymore. We've got enough revenues to cover our added spending.' "

I agree with that; I believe the President does too. Some revenues have to be raised to deal with the deficit, but the emphasis must be on spending restraint. We cannot accept revenue increases that are not linked to substantial spending cuts. My point is just this: indexing taxes is a political reform as well as the most significant protection against higher taxes for all working Americans. In the long run it will mean even more for taxpayers than the series of rate cuts we have put in place. protection against bracket creep is crucial for all taxpayers, regardless of their income—but it is particularly important for taxpayers at low and moderate incomes, who have less discretionary income and are at greater risk of being shunted into a higher bracket.

Our goal is to end inflation and get the economy moving. We have had considerable success on inflation, which is why I have suggested the possibility of indexing earlier in lieu of the 1983 rate cut. Not because we do not need rate cuts—but because lower inflation, reducing bracket creep, does part of the job of rate stabilization that was intended in the 1981 tax bill. Obviously I would prefer, as does the President, leaving the individual tax cuts intact and looking elsewhere for revenues.

Some of us have suggested other options, including minimum taxes and narrowing the compliance gap. But if we do have to compromise, indexing should be the last place we look. Having got the genie in the bottle, we ought not to tamper with the notion of unleashing bracket creep again.

OPENING REMARKS OF SENATOR LLOYD BENTSEN

We have to stop looking at this, Mr. Director, as a Democratic economy or a Republican economy. It's and American economy.

We in the Congress have to work with the Administration in a spirit of bipartisan cooperation if we expect to resolve our budget difficulties and get the American economy back on track.

This is one Democrat who stands ready to do that. And I'm not alone. There are a lot of us in Congress.

But I don't mind telling you that shrill, partisan attacks against Democrats such as those the President is reported to have made yesterday, don't help any of us.

I wish you would go back to the White House with a message to the President that it is not true that Democratic policies call for "planned deficits" and "deliberate inflation."

It is not true and that kind of talk is not helpful.

If he continues these kinds of partisan attacks then, sooner or later, some Democrat is going to remind him that the only federal budget to show a surplus over the past 23 years was written by a Democratic President. The only one.

If these attacks continue, some Democrat is going to charge that Republican policies deliberately throw people out of work.

The fact is, Mr. Director, this country is in a recession and the Republicans are in the White House and the American people are fully aware of this and if the President prefers a political battle to an honest, bipartisan effort to resolve our difficulties * * * then I wish you'd tell him for me that he can't win.

Worse than that, the American people can't win. It serves no good purpose and can only cause harm to our national interest.

Tell the President for me, Mr. Director, that I want to work with him. Tell him that a lot of Democrats in Congress stand ready to work with him. We demonstrated that last year. Congress last year gave the President virtually everything he asked for.

We must continue working together, to reduce this terrible budget deficit. We must work together to bring down interest rates. I would especially like to see a bipartisan effort to convince the Federal Reserve Board to change their policies, as part of our effort to bring down interest rates. Between Congress and the White House—if we make a concerted effort—we ought to be able to convince the Fed that there is a great difference between independence and isolation.

Which brings me to my first question. How much of the budget deficit would you say is brought on by high interest rates? What percent? Is that available? I know high interest rates brought on the recession and I know that high interest rates mean the government has to pay a lot more for the money it borrows, and it's borrowing a lot more these days. Those two factors alone add substantially to the deficit. How do you measure the impact?

The CHAIRMAN. We are very pleased to have Mr. Stockman with us this morning. I might say before we begin that we will follow the early bird rule. First here; first up.

Senator Byrd, do you have a statement you would like to make?

Senator BYRD. Thank you, Mr. Chairman. I think I will wait until after Mr. Stockman's testimony.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. No, Mr. Chairman. I would like to hear this first.

The Chairman. Well I will just say a few words. Yesterday, Secretary Schweiker was here, and I suggested to him that maybe one way to tell his story would be to run an ad because it is difficult sometimes for the press to understand that the budgets are big. I would like to put in the record the report of the hearing yesterday that appeared in the New York Times.

[The newspaper item follows:]

SEVERAL INTEREST GROUPS PREPARED TO ACCEPT CURBS ON U.S. BENEFITS

(By Robert D. Hershey, Jr.)

WASHINGTON, March 9.—Several interest groups for the elderly and others now say they might accept smaller Federal benefits than planned so long as the reductions were part of a broad effort to curb spending that shared the sacrifice fairly.

This sentiment, in response to several Congressional proposals to freeze or cut certain benefit programs, is being reflected in the groups' internal discussions and has in some cases been conveyed to Congress and the Reagan Administration. It contrasts with the strong and widespread opposition last year to the President's idea of tightening the eligibility rules for Social Security.

The programs are those under which people are entitled to benefits as long as they meet certain eligibility criteria. Such entitlements, sometimes referred to as uncontrollables or automatic spending, account for about half the Federal budget, with Social Security itself accounting for nearly half the entitlements and with Medicare, the Federal health program for the elderly, accounting for billions of dollars more.

The willingness by some groups to accept unpalatable measures appears to be prompted by huge budget deficits, which are officially projected by the Administration at $96.4 billion for the fiscal year 1983 but which, according to many analysts, may run far higher.

DISAGREEMENT ON CURBS

"Old people, like everyone else, want the budget brought into balance," said James M. Hacking, assistant legislative counsel for the American Association of Retired Persons and the National Retired Teachers Association.

Among the groups that say they might be receptive to some sort of entitlement curbs, besides the A.A.R.P., are the American Legion and the Disabled American Veterans.

Not all interest groups, however, are willing to say they would accept such cuts. Gary DiNunno, a spokesman for the American Federation of Government Employees, which represents 700,000 workers, said his members "are losing ground to inflation" and added that many were being furloughed from Federal jobs.

He said that while there might have to be cuts in planned benefits, "we're going to work hard to find budget cuts in other areas."

Many financial analysts, particularly on Wall Street, believe that only by imposing substantially more ambitious curbs on entitlement benefits than have been adopted or proposed by the Administration so far, can Federal spending be brought under control and economic recovery assured.

"If you want to catch fish, you got to go where the fish are, and if you want to save money you have got to go where the bucks are," Representative W. Eugene Johnson 3d, a North Carolina Republican, said at a recent meeting of the Task Force on Entitlements, Uncontrollables and Indexing.

At that session David A. Stockman, the Administration's budget chief, noted that from 1970 to 1980 Social Security, medical and other entitlement benefits soared to $261 billion from $62 billion, an average annual growth of 15 percent. The programs' share of the Federal budget rose by nearly half, to 45.4 percent.

ALTERNATIVES ON BUDGET

At least two alternatives to the Administration's 1983 budget, from Pete V. Domenici, head of the Senate Budget Committee, and Ernest F. Hollings, its ranking minority member, have involved some assault on such spending. These are now being seriously considered by recipient groups, though Mr. Domenici has not specified his ideas.

If a freeze on benefits, such as proposed by Senator Hollings, was applied across the board and included Social Security, "we'd be pretty hard-pressed to oppose that," commented Charles E. Joeckel, deputy legislative director of the disabled veterans group. "Our programs are big but we don't think we can bear it all," he said.

E. Philip Riggin, legislative director of the American Legion, said, "We're willing to seriously consider fair, across-the-board, equitably distributed entitlement adjustments." The alternative, he added, "would be to place Congress and the Administration in the position of haggling over an entire laundry list of other cuts."

SIGNALS TO ADMINISTRATION

The Administration, which appears still unwilling to compromise on its budget proposals, including a big increase in military spending and no large tax increases, has apparently not begun to approach the groups that represent entitlement recipients but it has been told about the willingness of various groups to consider curbs.

"Just about all the interest groups are saying entitlements are not a sacred cow," Elizabeth H. Dole, President Reagan's assistant for public liaison, said today.

Meanwhile, Richard S. Schweiker, Secretary of Health and Human Services, said that the Administration would not seek any change in the Social Security cost-of-living adjustment before a special study panel makes its report late this year.

He seemed also to indicate that the Administration would not support any such proposal generated by Congress before then but he would not allow himself to be pinned down on that point.

The subject was raised at a hearing of the Senate Finance Committee by John H. Chafee, Republican of Rhode Island. Mr. Schweiker agreed with Senator Chafee's suggestion that the Administration did not intend to propose Social Security changes as part of the budget-cutting process but would do so as part of the effort to protect the integrity of the system.

Mr. Hacking of the A.A.R.P. insisted, that "we cannot give up cost-of-living adjustments" but after that "other things drop down in priority."

The **CHAIRMAN**. According to the story, I'm not certain whether Schweiker was even here. But I think it would be nice to have this record to indicate just how objective the reporting is.

The HHS budget is $284 billion in fiscal year 1983. An 8-percent increase over this fiscal year. The Secretary with rather good charts, I thought, suggested about 95 percent of his budget is entitlement programs. We obviously need to take a look at those. Somehow that was not indicated in the newspaper report. It is an indication that it is difficult, at best, to let the American people know that we do have some budget problems and that we are in a fiscal crunch, and that it may be necessary for some programs to be reduced. I think with that, Mr. Stockman, we will be pleased to have your testimony unless Senator Bentsen wishes to make an opening statement.

Senator **BENTSEN**. I would like to make some comments, if I may, Mr. Chairman.

Mr. Director, I think it is time we stopped looking at this economy as a Republican economy or a Democratic economy. It is the American economy. We, in the Congress, have to work with this administration if we are going to resolve this budget deficit; if we are going to get the American economy back on the track. I am one Democrat who is ready to work at doing that, and there are a lot more in the Congress willing to do that. But shrill and partisan attacks against the Democrats, such as those the President was reported to have made yesterday, really don't help in that regard. Please tell the White House that it is not true that Democratic policies call for a planned deficit and a planned inflation. That kind of talk is just not going to be helpful.

If the President continues to make those kind of partisan attacks, sooner or later some Democrat is going to remind him that the last balanced budget was drafted by a Democratic President. If those attacks continue, some Democrat is going to charge that Republican policies deliberately throw people out of work.

The fact is, Mr. Director, this country is in a recession, and it is the Republicans who are in the White House. The American people are fully aware of this. And if the President prefers a political battle to an honest bipartisan effort to resolve our difficulty, then you can advise him that he can't win. Worse than that, the American people can't win. It serves no good purpose, and it causes harm to the national interest.

Tell the President for me, Mr. Director, that I want to work with him. Tell him that a lot of Democrats in Congress want to work with him. We demonstrated that last year when Congress gave the President virtually everything he asked for. We have to work together to reduce this budget deficit. We have to work together to bring down interest rates. Moreover, we need a bipartisan effort to convince the Federal Reserve to change some of their policies as a part of our efforts to bring down interest rates. Between the Congress and the White House, if we make a concerted effort, we ought to be able to convince the Federal Reserve that there is a great difference between independence and isolation.

That brings me to my first question. How much of the budget deficit would you say was brought on by high interest rates? What percentage? Is that information available?

I know that high interest rates brought on this recession, and that high interest rates mean that the Government has to pay a lot more for the money it is borrowing. Those two factors alone add substantially to the deficit. My question is how much of the current budget deficit do you think has been caused by high interest rates?

Thank you very much, Mr. Chairman.

The **Chairman**. Thank you. Well, I won't respond to what Senator Bentsen said although I was at the meeting. I don't recall any shrill attacks by the President on Democrats. I think, in fact, it was a very conciliatory meeting. He didn't even attack any Republicans. [Laughter.]

So I don't know where that story may have originated.

Senator **Bentsen**. It's in the press, Mr. Chairman.

The **Chairman**. Oh, well, that wouldn't be an indication that it was accurate. [Laughter.]

But having been there, and I think I was there every moment, what the President may have suggested was that if, in fact, there is this bipartisan effort, he would certainly be willing to look at it. I agree that we are going to need your help, Senator Bentsen, and Senator Byrd's, and others, or we aren't going to have any agreement or a bipartisan package.

Well, Dave.

STATEMENT OF HON. DAVID A. STOCKMAN, OFFICE OF MANAGEMENT AND BUDGET

Mr. **Stockman**. Well, thank you very much, Mr. Chairman. I appreciate very much this morning your expedited procedure on these hearings without opening statements. Perhaps I can reciprocate by suggesting that I would prefer to put my statement in the record—maybe summarize very quickly a few brief points—then proceed to the questions because I know the question asked by Senator Bentsen is a good one. Other members of the committee will have other important substantive questions that we must deal with if we are to treat and cope with this deficit problem.

I have about three observations to make, Mr. Chairman. The first is that under any economic forecast that you use, we face huge and rising budget deficits in 1983 and the out-years. Those deficits range between $130 billion up to $216 billion over that 3-year period, depending on which set of economic variables you use for GNP, interest rates and so forth. That is the common problem that we must deal with and it can't be wished away. It can't be removed simply by changing the expected economic forecast or path over the next several years.

Second, we know that deficits of that magnitude would be a severe threat to the kind of economic recovery we desperately need and that I think everyone on this committee and in this Congress, on a bipartisan basis, is dedicated to achieving. So we have a great policy task before us, and that task is simply to shape a package of unprecedented size and dimension and difficulty that can reduce those current services deficits that we face at the present time.

Third, I will say those large deficits have suddenly appeared because there have been such dramatic and massive changes in the current and prospected economic outlook since we began to shape a fiscal plan last year.

I have noted for the budget committees and I will underscore again for this committee that those deficits are the result of the much more rapid reduction in inflation than we anticipated, and the much deeper and more prolonged recession than we anticipated. Combined, these changes in the economic outlook will dramatically reduce the path of nominal GNP over the 1983–85 period that you will be dealing with in your legislative action this year. GNP will be lower by over $176 billion in 1983 and by nearly a quarter of a trillion by 1985, compared to what we or CBO forecasted last year.

Now the reason that I stress this is that the budgetary receipts that we collect from the business sector and the household sector are linked directly to the level of nominal income in the economy. Since we now face a path of much lower nominal income due to the progress on inflation and due to the setback on recession, we will have revenues that are at least $50 billion lower in 1983 than anyone forecast last year. Revenues will be $60 or $70 billion lower by the out-years than almost anyone forecast. That is the heart of the new fiscal circumstance or picture that we face and we must find ways to deal with it.

Similarly, to try to respond to Senator Bentsen's opening question, I would point out that over the 1970's, we had a normal circumstance in which the interest rate tracked fairly closely to the inflation rate. And, indeed, during much of that decade the T-bill rate on which we finance most of the Federal debt tracked behind the inflation rate, which meant that we had the good fortune to finance the Federal debt at the negative rate of return. But the markets caught up with that; investors would not put up with that indefinitely. In late 1980 and 1981, a huge premium between the current inflation rate and the nominal interest rate opened up, which is now, as you know, 4, 5, or 6 percent. We expect that premium will come down, but we think it will take time and the serious treatment of the budget deficit issue. We think it will take time to restore credibility of both fiscal and monetary policy before the markets can be permanently convinced that inflation is down to stay, and that this is not simply a temporary respite.

As a result of that sudden appearance of this large premium in the interest rate and now the higher nominal interest rates that we are projecting in this year's budget, combined with the higher deficits that result from lower revenues, we are faced with an outlay increase of $31 billion for debt service costs in 1983 and nearly $107 billion, cumulative, in outlays over the 1983–85 period compared to what we were expecting last year.

Now if you factor those variables together—the reduced path of nominal GNP on receipts and the much higher level of debts and interest related costs—you have most of the explanation, most of the story as to why we are dealing with a $150 billion current services deficit. It will do no good to try to reconstruct the policy actions or economic events of last year. They are simply facts of life that we now must deal with as we face the fiscal year 1983 and future budgets.

The second point I would make relates to the specific area of entitlements, which is a heavy and important jurisdiction of this committee. I understand that Secretary Schweiker was here yesterday and went through considerable program detail with you. I would only point out today that we inherited the situation in 1981 in which the combined entitlements of the Federal Government had grown from $62 billion to $262 billion between 1970 and 1980. Those entitlements, the whole set combined from military retirement to social security, food stamps, medicaid, and the other entitlements, had increased at a 15-percent compounded rate each and every year during the 1970's.

As a result of the effort we made last year to begin to curb that totally unacceptable and unforeseeable rate of growth, we have reduced entitlement spending by about $69 billion between 1982 and 1987. We have put that into law, largely as the work of this committee last year.

Now that sounds like a substantial change. And it was an important start. But the committee needs to understand that over the next 5 budget years, we will spend over $2 trillion on the entire set of Federal entitlements. As important and significant as that set of changes and reforms were last year, the $69 billion, it will amount to only 3 percent of the base line spending for entitlements that was in the law when we began to address this issue last year.

As a result, we have proposed in this budget a further round of entitlement changes in many of the programs that are in the jurisdiction of this committee. I realize that many of these changes will be difficult, especially under current circumstances and given the pressures that are brought to bear. But unless we can somehow slow down this built in growth rate for entitlements—which is projected to exceed 8½ percent annually over the next 5 years, a rate far in excess of projected inflation—there is simply no way that we can hope to reduce this built in budget deficit and restore fiscal equilibrium in the years ahead.

Therefore, as we carry on the discussion this morning and in the weeks ahead, I would urge the committee to take a very careful look at the detailed programmatic changes that we have proposed in medicare, medicaid, AFDC, and other areas. If you feel these changes aren't warranted, come up with alternative proposals that would achieve the same kind of restraint and the same kind of reduced rates of budget growth, because without a serious addressing of those areas, we simply can't solve this problem.

The final point I would make this morning, Mr. Chairman, is that under the current fiscal circumstances that we face in which the threat is so severe and the problem is so large, there is a tendency to look for simple formulas to deal with the entitlement programs such as a freeze, a cap, or a delay. I don't believe that those formulas should be ruled out under current circumstances. We simply may not have the time or the capacity to do anything more.

But I would also point out to the committee that this fiscal problem that we have is not a 1-year program, it's a permanent problem. A solution to the entitlement growth problem simply cannot be achieved by a one time expedient, nor can we fairly and justifiably impose caps or freezes or delays on a permanent basis. The reason is fairly obvious, and that is that the beneficiaries of Federal entitlement programs vary radically in their circumstances and their needs, and that some kind of uniform formula simply does not treat with or recognize those differences in needs.

In other words, freezes, caps, or delays, are perhaps an appropriate temporary solution, but not a permanent solution. For example, if you take the entire Federal entitlement structure, you will find that at the top there are people receiving $33,000 a year in Federal retirement payments—a GS-14 retired 10 years—and there are other people receiving $3,300 a year—an SSI beneficiary with no other outside source of income. Now that's a 10 to 1 disparity between the top of the benefit range and the bottom of the benefit range under this enormous complex of entitlement programs. Clearly, the impact of any sustained or permanent freeze or across-the-board change would be very severe on the bottom and much more tolerable on the top.

I simply mention this to point out that even as we perhaps look for temporary expedients to slow the cost growth of entitlements and to achieve immediate budget savings to reduce the deficit, we must not neglect the on-going work of permanent structural reform targeted in a programmatic and specific way, as this committee did last year, in order to deal with the outyear entitlement problem and the permanent problem of growth.

Those are my initial comments. They summarize some of the more important points in my testimony, Mr. Chairman. And having made those points, I would be very happy to proceed with the questions of the Committee.

[The prepared statement follows:]

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

FOR RELEASE ON DELIVERY
Expected at 10:00 a.m.
Wednesday, March 10, 1982

TESTIMONY OF THE HONORABLE DAVID A. STOCKMAN
BEFORE THE
SENATE FINANCE COMMITTEE

MR. CHAIRMAN:

I am pleased to appear before you to discuss aspects of the FY 83 budget of particular interest to your Committee. I would like to review the highlights of the overall budget picture in terms of the deficit and budget aggregates and then focus for a moment on two issues that I know are of great concern to this Committee, the explosive growth in entitlement programs, and the incentive effects of our proposals on the working poor. I will briefly review the common-sense diagnosis of the entitlement and incentives problems, the progress we have made to date, and the thrust of the President's new initiatives.

First, on the overall fiscal situation, I would remind the Committee that current deficit projections, absent Congressional action, indicate serious danger to economic recovery, the stability of financial markets and the economic well-being of every American. I think we all understand this fact, but it is an important starting point for our deliberations on the FY 83 budget. Without a sweeping and comprehensive budget savings plan for 1983 and the outyears, we face unprecedented, massive and rising Federal deficits each year.

A range of estimated deficit paths at current services, which assumes no further policy actions from what is in the budget today for Fiscal Years 1983 through 1985, suggest the dimension of the fiscal problem. Under a variety of economic assumptions, both optimistic, pessimistic and somewhere in between, current services deficit projections far transcend plausible differences in economic assumptions. These estimates indicate the magnitude of the fiscal problem, with its potential detrimental impact on the economy and the financial markets if we fail to deal with it.

Current services deficit estimates range from $129 to $162 billion in 1983 rising to the $133 to $197 billion range in 1984 and from $120 to over $200 billion in 1985, depending on whose economic assumptions one uses.

The second point I would like to highlight about the budget, Mr. Chairman, is that there is more to this budget that the Administration has presented than simply the bottom line, although that has received most of the attention and most of the discussion. The deficits are important, but what lies behind them in terms of the comprehensive plan to reduce these deficits is, in my judgment, even more important.

This budget provides a comprehensive plan to reduce the deficits by 50 percent from the large numbers that I have just cited over the next three years. Deficits would be reduced by $56 billion in 1983 through a variety of measures: revenue, entitlement, discretionary, user fees and management initiatives. These savings increase to $84 billion by 1984 and nearly $100 billion by 1985.

The third point I would make about the overall budget, Mr. Chairman, is that these dramatic changes in the budgetary outlook -- in the magnitude of the deficits that we are dealing with both on a current service and after policy action basis -- result primarily from changes in the economic outlook, both current and prospective, which have had major adverse impacts on the budget. The combined impact of much higher interest rates than we expected, a recession that we did not expect, and an inflation rate that is falling faster than anyone anticipated, has been to increase the deficit in 1982 by $31 to $57 billion, depending on which forecast you use from last year. The deficit is also increased by $40 to $89 billion in Fiscal Year 1983, the budget year before us, again depending on which forecast you use.

The recession and reduced inflation together will reduce nominal GNP dramatically in 1982 and outyears and, of course, it is nominal GNP that determines the level of government receipts -- the taxes that we receive from businesses and households.

Compared to what we expected last year, nominal GNP would be $176 billion lower in 1983. By 1985 those differences are even larger. Nominal GNP would be $291 billion lower than what CBO forecast last year and $242 billion, or nearly a quarter of a trillion dollars lower, than what we forecast last year. This much lower prospective path of nominal GNP reflecting the recession, reflecting a more rapidly declining rate of inflation, and reflecting continued moderation in monetary policy and growth of the money supply, means that budget receipts will be $30 billion lower in 1983 than CBO projected or $31 billion lower than we projected one year ago.

By 1985 the change in the outlook for nominal GNP will mean revenues $71 billion lower than CBO projected and $60 billion lower than we projected. That is the major change in the economic outlook, and you can see it has a large and dramatic effect in decreasing the level of revenues.

The other major change in the economic outlook relates to interest rates. As we all know, last year we experienced something unprecedented in the economic performance of the last decade or perhaps even the Post-War period. Historically, the interest rate has tracked very closely to the inflation rate -- indeed, during the 1970's the T-Bill rate was actually lower than the inflation rate much of the time, which meant we were financing our Federal debt at a negative rate of return, a bargain for the government -- but that picture changed dramatically during 1981 as the financial markets caught up and demanded a premium above the inflation rate of unprecedented size.

No one can adequately explain or predict whether or how long these interest rates and premiums will last. Some call it an uncertainty premium, some call it a volatility premium, and some call it a risk premium. Whatever the explanation, it is there and it is increasing dramatically the debt service cost of the government both in the current budget year and prospectively. We believe that as the inflation rate comes down the interest rate will come down gradually with it, and that as market stability and credibility are restored, these unusual and unprecedented premiums will begin to diminish. Nevertheless, under the forecast we are now using, the effect of interest rate premiums on interest-related outlays will be to add $31 billion in 1983 and $107 billion to outlays over the next three budget years.

If you add together the impact of lower projections for nominal GNP on receipts and the impact of interest rates on debt service outlays, you have about 90 percent of the change from the deficit projections that we and others looked at last year.

Further, the Committee might be interested to note that the current budget outlook would not be substantially different if Congress had adopted the major fiscal alternatives considered last year. For instance, similarly large current service deficits result from either the Administration tax program as adopted, or the alternative House Ways and Means Committee tax program rejected by the Congress.

Had the House Ways and Means Committee tax bill been adopted, the third-year of the individual rate cut would not likely be triggered in January 1984 as provided by the bill. Nevertheless, due to other provisions of the Ways and Means alternative, the FY 82-84 static revenue cost would have been similar to that of ERTA:

TABLE I

(Billions of Dollars)

Economic Recovery Tax Act revenue cost, FY 82-84	- 269
Ways and Means Tax Alternative FY 82-84 without third year rate cut	-253

As a consequence, current services deficit projections for FY 82-84 are nearly identical when based on common economic assumptions. In both cases, a large, unanticipated fiscal problem looms on the horizon due to changed economic circumstances and outlook.

The current services deficit that results from the interaction of these economic factors requires urgent action this year of roughly the same magnitude as last year.

ENTITLEMENTS

Now I would like to focus for a few moments on one area of great interest to this Committee -- entitlements. To assist this Committee's deliberations, I would like to briefly put our entitlement programs in historical context, because, in a sense, the validity of the cuts or changes or reforms that we are proposing at the present time depend in part upon the acceptability and justification for the enormous benefits expansions which occurred earlier and which, therefore, create the base of benefits and expenditures that we must confront and cope with at the present time.

The following table tells the basic story in terms of the historical trend and base of entitlement spending that we have today.

TABLE II

ENTITLEMENTS GROWTH IN THE 1970'S
(Millions of Dollars)

	1970	1975	1980	1970-1980 Average Annual Growth Rates
Social Security 1/......	31.2	68.3	121.4	14.2%
Medical.................	9.9	21.6	49.0	16.9%
Other...................	21.4	57.3	90.9	15.2%
Total................	62.4	147.2	261.3	15.0%
Share of Budget.........	31.9	45.4	45.4	
Share of GNP............	6.4	10.0	10.2	

1/ Includes Railroad Retirement

Between 1970 and 1980, one decade, entitlement costs literally exploded in terms of their impact on the budget and their coverage of various eligible people.

Entitlement costs rose from $62 billion in 1970 to $261 billion by 1980 -- a 15 percent annual rate of growth each and every year -- well over double the inflation rate that we had during that period.

Perhaps more significantly, in terms of the leadership this committee must provide in allocating budget resources, the share of the budget accounted for by entitlement programs grew in that decade from less than a third to nearly one-half.

If we place this trend in even longer historical perspective, I think the message is even more dramatic.

The costs of all entitlement programs combined 25 years ago, in 1955, amounted to 3.4 percent of the GNP. By 1981, that claim of our entitlement programs alone on the Gross National Product had increased from 3.4 percent to nearly 11 percent, more than a three-fold increase over the 25-year period.

TABLE III

Outlays as a Percentage of GNP and the Budget

	1955	1965	1975	1981
Social Security....................	7.3	15.3	21.1	22.1
Medical...........................	---	.2	6.7	9.0
All Other.........................	11.7	11.5	17.7	15.5
Entitlements as a share of Budget..	19.0	27.0	45.4	46.5
Entitlements as a share of GNP.....	3.4	4.8	10.0	10.7

I think the policy implication of that historic backdrop and trend was very clear by 1981 as we set out to work last year. The implication was simply that unless the growth rate of this combined set of entitlement programs was somehow slowed down, then it was obvious that in a very short period of time, entitlements would either drive out of the budget other commitments that we have to discretionary activities, to traditional functions of the Federal Government, to national defense and so forth, or alternatively, they would increase substantially the tax burden on the American people and on our economy to levels that would become clearly counter-productive and excessive.

I present this background, Mr. Chairman, because the entitlement reform policy that we have adopted and proposed is designed to avoid both of these eventualities, which were built into the trend of growth that we confronted in 1981. We would do so by reducing rather substantially the overall growth rate of entitlement spending and thereby slowing down the growing preemption of both budget resources and national income that was implicit in these 15 percent annual rates of growth year in and year out.

As we began last year, it was obvious that this 15 percent growth pattern could not continue. Fifteen percent growth per year from the FY 81 base would have equaled about $615 billion by FY 86 or 13.2 percent of GNP compared to 5 percent in FY 65.

In the following table, we demonstrate both the enacted and the newly proposed entitlement reforms and savings that are part of this strategy and the impact of these measures, the total budget savings, on the current law entitlement base as it existed in January 1981 when we began this long overdue process of reforming and constraining the growth of the entitlement system.

TABLE IV

Entitlement Changes FY 81-86

(Outlays in Billions of Dollars)

							Average Annual Growth Rates	
	1981	1982	1983	1984	1985	1986	70-80	81-86
Current Services (1/81)...............	305.3	352.0	385.5	412.0	441.1	472.8	--	9.1%
Enacted Changes.......	+.4	-10.6	-14.8	-14.2	-12.2	-12.6	--	8.5%
Proposed Changes in 83 Budget.........	--	-1.4	-12.8	-18.1	-23.8	-29.4	--	--
Total After Savings	305.8	340.0	357.9	379.7	405.2	430.8	15.0%	7.1%

The historic Reconciliation Bill passed by the Congress last summer will result in about $65 billion less spending for entitlements over the 1982-1986 period than would have otherwise been the case had the pre-1981 growth rate continued to hurtle forward at its previous pace.

But note that while this number sounds large in the aggregate, $65 billion in budget savings over a five-year period only amounts to a reduction in the growth rate that was built into current law as of January 1981 from 9.1 percent to 8.5 percent, a relatively modest downward shift.

Perhaps to put it more dramatically, that $65 billion in savings that has now been enacted amounts to only 3 percent of the $2 trillion that we would have otherwise spent for entitlement programs over the 1982-86 period on the basis of current law as it existed in January of last year.

So obviously we made a start last year. But I think when viewed in that perspective, in terms of budgetary impact and fiscal policy implication, it was a start, but very little more than that.

And so, therefore, in the fiscal year 1983 budget, we have proposed a new round of additional entitlement reforms designed to reduce further the growth rate of entitlement spending, target better the benefits to those who truly need them, and in the process, save an amount even larger than the $65 billion five-year savings enacted last year.

Total entitlement savings in our budget plan for fiscal year 1983 would amount to $86 billion over the next five years. But even then, if these savings were agreed to and implemented by the Congress, it would only lower the growth rate to 7.1 percent or about four-fifths of that baseline that I mentioned before that was built into the entitlement structures as of January 1981.

Nevertheless, as modest a reduction as this might seem, when viewed in the context of the much more rapid growth of coverage and real benefits in the 1970's, it would have to be considered a major fiscal accomplishment.

A 7.1 percent growth rate for the first half of the 1980's would be less than one-half of the 15 percent growth rate we had in the last decade. Moreover, as we know, the inflation rate is coming down rapidly. We expect an average inflation rate of 5 percent or 5-1/2 percent in our forecast over the next five years, and even that may be high.

But if that is the case, then the entitlement growth rate at 7 percent would only be slightly higher than the inflation rate, and that would mean that the real rate of expansion, or the real growth, of budget resources required by entitlements, would be quite modest over the next four or five years.

What I would like to suggest with respect to the entitlement problem that this Committee is concerned with, is that this plan represents a basic shift, a shift from a policy environment and a policy direction characterized by rapid expansion of coverage and real benefit levels in the 1970's to one characterized by a substantial constraint, by no additional expansion of the entitlement base, but still modest real growth for the 1980's.

ENTITLEMENT COMPONENTS

Another factor this Committee should consider, Mr. Chairman, is that with aggregates of this magnitude -- when you are dealing with $358 billion worth of entitlement spending in the FY 1983 budget -- it is important to look at entitlements from a fiscal policy point of view because the programs have to be funded if they are not changed.

But in terms of some of the more detailed and precise policy considerations that this Committee will have to grapple with, aggregates tell only a limited part of the story. We must seek to examine more detailed levels of components and programs in order to get better insights as to the choices and trade-offs that we have available.

And for that purpose, I have divided the entire set of entitlements into three basic categories, because I think the policy issues and the fiscal directions embodied in these three basic categories are very different.

Those categories are medical entitlements, which basically present us with a problem in the structure of the private health care delivery and payment system; Social Security, which presents us with a trust fund solvency and intergenerational commitment problem; and all other entitlements, ranging from food stamps to Federal civil service and military retirement, which present us with pure policy issues, in terms of benefit levels and eligibility criteria that have to be dealt with on their own technical terms.

If you look at these three categories, you see a very distinct pattern in terms of budgetary impact.

MEDICAL PROGRAMS

Medical programs are slated under current law for rapid and unsustainable 14 percent compounded growth over the next five or six years unless major reforms in both the entitlement structure and in the health care delivery and financing system can be achieved.

Thus far, as the following table shows, the enacted savings in the medical component of the entitlement structure have been almost neglible compared to the base of spending.

TABLE V

Medical Programs Entitlement Changes, FY 81-86

(Outlays in Billions of Dollars)

	1981	1982	1983	1984	1985	1986	Average Growth 70-80	Annual Rates 81-86
Current services (1/81)..............	58.8	69.6	78.3	89.0	101.4	114.8	--	14.3%
Enacted changes......	.5	-1.6	-1.5	-1.8	-1.0	-1.3	--	13.9%
Proposed changes in 83 Budget 1/.....	--	-.6	-4.5	-7.5	-11.6	-15.7	--	--
Revised Total	59.3	67.4	72.4	79.8	88.8	97.8	17.4%	10.5%

1/ Includes Administrative Actions

And what that suggests, Mr. Chairman, is that if we are going to deal with the entire entitlement burden on the budget, then this component is clearly the leading area to be addressed for coming up with creative solutions, because it is the leading edge in terms of the rate of growth and the increase in the fiscal burden.

Now there will be substantial controversy over the reforms that we have presented in the FY 83 budget for the Medicaid and Medicare programs, but they do represent $40 billion worth of savings over the next five years. They will also reduce the built-in growth rate from more than 14 to 10-1/2 percent.

In the area of Medicare, the Administration is proposing the adoption of many cost-saving changes which your Committee has considered in the past. Some call for rethinking of our present reimbursement system; others are simple common sense.

In the latter category, we propose repeal of a vestigial provision from the early days of Medicare which permitted reimbursement for uncovered services, on the grounds that physicians didn't know what was covered.

In the former category, we propose to adjust allowable physician fees for services performed in hospital outpatient departments to reflect the fact that physician office overhead costs are an appropriate cost in the physician's office -- where those costs are actually incurred -- and not appropriate in settings where the physician has no overhead costs at all.

Other proposed changes include --

-- establishing HI coverage for Federal workers

-- making Medicare a secondary payer when beneficiaries have employer-paid health insurance;

-- eliminating subsidies in the cost structure for private rooms;

-- delaying and restraining upward adjustments in maximum allowable fees;

- -- indexing SMI deductibles; and
- -- other reasonable technical and conforming changes.

SOCIAL SECURITY

The second component of the entitlement structure is the Social Security program, which accounts for nearly half of all entitlement spending.

Benefit payments under the Old Age and Survivors Insurance and Disability Insurance portions of the Social Security system will continue to rise throughout the period. It must be noted that present OASDI revenues are insufficient to finance this outlay path.

TABLE VI

Social Security[1/]

Entitlement Growth FY 81-86

(Outlays in Billions of Dollars)

	1981	1982	1983	1984	1985	1986	Average Growth 70-80	Annual Rates 81-86
Outlays......	143.4	160.3	173.5	188.5	202.3	216.5	14.2%	8.4%

[1/] Includes Social Security payments to railroad retirees.

Action in this area, however, awaits a bipartisan consensus on the best method of putting the Social Security system on a sound financial footing.

OTHER ENTITLEMENTS

The third component of the entitlement structure very briefly, Mr. Chairman, mainly covers Federal retirement benefits and a whole range of means-tested entitlement programs like SSI, AFDC, and food stamps.

The combined effect of both the enacted changes and the proposed changes in this area will be to reduce the growth rate of spending for the non-medical, non-Social Security entitlements to a little under 3 percent over the next five years. Basically, we see a picture of no real growth, but no shrinkage either in these entitlements as illustrated in the following table.

TABLE VII

Other Entitlement Changes[1] FY 81-86

(Outlays in Billions of Dollars)

	1981	1982	1983	1984	1985	1986	70-80	81-86
Current services (1/81)...............	101.6	117.7	127.6	127.2	129.8	133.3	--	5.6%
Enacted changes.......	--	-6.2	-9.2	-7.5	-5.8	-5.7	--	4.7%
Proposed changes in 83 Budget 1/......	--	-.8	-6.4	-8.4	-9.8	-11.1	--	--
Total................	101.6	110.6	112.0	111.4	114.2	116.5	15.0%	2.8%

---

[1] Includes all entitlements except Social Security, Medicare and Medicaid

Note that some of the flattening out of spending in this entitlement area merely reflects our economic forecast and has to do with the fact that this component of the entitlement structure includes unemployment insurance and other unemployment-sensitive entitlement programs. Since our forecast assumes a strong recovery lasting through the entire budget projection period, spending for unemployment insurance is expected to fall and there is less pressure on the other unemployment-sensitive entitlement programs.

TWO APPROACHES TO RESTRAINING THE GROWTH IN ENTITLEMENTS

As we sat down last year and looked at an entitlement structure growing at a 15 percent rate, heading for spending of a half a trillion dollars in a very few years, it was very clear that we had one of two basic routes to take in terms of a policy strategy if we wanted to achieve major savings.

One was across-the-board reductions, which, I will argue, is only appropriate as a temporary expedient. The other was some kind of targeted, selective, permanent change in the entitlement structure designed to tighten that structure and better focus it on those with demonstrable needs.

As we looked at those basic strategies, the across-the-board strategy, which we rejected, had a great deal of appeal. I think it is obvious to Members of this Committee, as well, why that appeal exists. With an across-the-board-type constraint on entitlement programs, depending on how severe the constraint, one can generate large savings and have major budget impact over time as a result of relatively modest changes through across-the-board type caps or formulas.

I offer the Committee today perhaps the most dramatic illustration of this point. If we were to simply freeze the current indexing structure in place at the levels that existed in 1982, which is to say after the 1982 COLA adjustments, for every program from food stamps to military retirement, and keep that freeze on for three years, through FY 85, the savings would rise from about $25 billion the first year to nearly $53 billion a year by 1985.

TABLE VIII

Cumulative Budgetary Increases Due to COLA's, FY 83-85[1/]

(Outlays in Billions of Dollars)

Programs	FY 83	FY 84	FY 85
Social Security COLAs.....	16.3	27.2	36.2
Other retirement COLAs....	6.1	9.2	11.6
Other entitlement COLAs...	2.5	3.9	5.0
Total......................	24.9	40.3	52.8

[1/] Additional program costs due to COLAs compared to the cost of maintaining benefits through FY 1985 at FY 1982 levels

However, in the process, we would have reduced the expected benefits of the average retired couple on Social Security by nearly a thousand dollars, not just the expected benefits of more well-off individuals.

Let me give the Committee an illustration of this problem, Mr. Chairman. If you were to freeze all indexed programs for one year, you would be freezing at one and the same time the benefits of a GS-15 retired for 10 years at $33,000 and the benefits of an SSI beneficiary with no other source of income or Social Security, of which there are hundreds of thousands, at $3,300. There is a 10 to 1 disparity between benefits under the annuity programs for retirement at the top and benefits under the income maintenance or means-tested programs at the bottom, and when you impose a freeze, you are imposing a freeze on individuals that are spread all the way across that spectrum, some 40 or 50 million people.

The point of this illustration is that across-the-board formulas or freezes cannot be justified as long-term solutions to the enormous growth built into the entitlement structure because of the similar way they treat beneficiaries in radically different circumstances. The only way to minimize the adverse effects of an across-the-board type approach on current beneficiaries is to significantly limit the duration of any freeze or payment cap.

Given this situation, last year's and this year's budget proposals, which were oriented toward making permanent changes in the entitlement structure, took the targeted, selective approach to entitlement reform. However, under the present conditions of fiscal urgency and with the kind of problems that we face today, we may have to consider temporary entitlement reform expedients of the type we have been discussing as well as the long-term, more permanent changes in entitlements proposed in the budget.

Mr. Chairman, I believe we face an enormous challenge in attempting to bring the growth rate of these entitlement programs into a range that is compatible with fiscal stability and balance, and in achieving the detailed specific reforms in this complicated structure of literally dozens of programs in a way that will meet the needs that have been either promised through social insurance programs in the past or that are evident by the income needs of various people in our society today.

THE WORKING POOR

Before I close, Mr. Chairman, I would like to address one other area of considerable interest to this committee -- work incentives in our welfare system and how our proposals affect them. For over fifteen years, analysts have focused on the effects of welfare program benefit guarantee levels and reduction rates as the key to understanding the problem of work disincentives in our welfare system. From the Family Assistance Program of the Nixon era to the Carter "welfare reform," conventional wisdom has held that only by reducing benefit reduction rates, and by providing recipients higher incomes for work than non-work, could we hope to move a substantial portion of the caseload off welfare.

While a more benign structure of benefit reduction rates has long been talked about, it has, to date, never been achieved. When President Reagan took office, the decade-long effort to reduce marginal benefit reduction rates had still left major cliffs and notches in our income support system. An unemployed father in a welfare household receiving $300 per month in cash assistance stood to lose that entire $300 per month in benefits -- and the similar value of Medicaid coverage to boot -- by increasing his hours of work from 99 to 100. Even in the more frequent case of a single mother moving from a part-time job at minimum wage to a full-time job at $4.00 per hour, the combined loss of cash and in-kind benefits produce "marginal tax rates," in many instances, well in excess of 100%.

The reason for these continued anomalies is an iron law controlling the feasible limits of means-tested entitlement programs that makes it literally impossible to fashion a program which simultaneously offers reasonable benefits and low benefit reduction rates.

A simple example illustrates this point. Consider a welfare system that provided benefits equivalent to $6,000 per year -- which would presently be in the high average range -- and taxed a recipients' benefits away at the low rate of 25 cents on a dollar earned. Such a system would provide cash welfare payments to every American family with an income under $24,000 -- or better than half the population. Every effort to lower the "tax rate" raises the "break even point" for continued benefits higher and higher into the middle class earning stream.

The only two "solutions" to this fundamental political impasse are no solutions at all: one must either dramatically slash benefits, or else increase the tax rate. In the example above, the break-even point could be reduced to the $12,000 income level (still, quite probably, too high) only by either cutting the basic benefit to $3,000, or by raising the tax rate to 50%.

Confronted with this paradox, the Federal government has erred on the side of keeping tax rates moderately high so as to permit the benefit level to be maintained at adequate levels. Any tax rate below 100%, however, has the effect of creating a permanent entitlement for those capable of supporting themselves through work. Because the "tax rate" problem cannot be solved, we have up to now maintained a benefit reduction scheme that has discouraged the vast majority of recipients from working, while maintaining permanent dependency for those who nevertheless do shrug off the disincentives and obtain productive employment.

The Administration's Proposals

The overall effect of the Administration's proposals is to finally break through this logjam by recognizing the inherent impossibility of "welfare reform" as we have construed it in the past. Based on the insight that means-tested entitlements, as presently constructed, will never solve the dilemma of work disincentives, we proposed, instead, to --

- Retarget assistance toward those who are not circumstantially capable of supporting themselves;
- Use tighter eligibility screens and absolute work-requirements, notably "workfare," to provide the needed work incentives for those who are capable;

- -- Limit special work-related incentives, such as the "thirty and one-third" income disregard, to temporary, rather than permanent assistance; and,
- -- Eschew all further fruitless efforts to mitigate high benefit loss rates.

Under the welfare regime proposed by the Administration, the charges of the critics that we are fostering "work disincentives" based on old-model perceptions of "welfare reform" are simply irrelevant. Rather than arguing forever whether a 70 percent tax rate on work is too high, the Administration proposes to turn the problem around, and establish a one hundred percent tax rate on non-work by those otherwise capable. Only in this way can we provide a cash welfare system that compassionately provides for those with nowhere else to turn, while assuring the American people that they will not be asked to support those who can support themselves.

This concludes my prepared remarks, Mr. Chairman. We face an enormous challenge in the budget areas this committee must address. I know this committee has studied and analyzed these problems very carefully and I look forward to our discussion today about your ideas, as well as ours, on how we can proceed.

WELFARE *IS* THE PROBLEM

David A. Stockman

Every session of Congress in the past decade has seen the start of a major effort to revise the tangled mass of transfer payment programs that constitute our nation's welfare system. Each of these efforts, including the one begun by the Carter Administration last year, has ended in a stalemate. The persistence of the stalemate is all the more remarkable in light of a near-universal perception of irremediable flaws in the existing system. The reasons underlying the rejection of such disparate approaches as the Nixon Administration's Family Assistance Plan and the Carter Administration's Program for Better Jobs and Income are only now becoming apparent.

Many serious watchers of the welfare reform debate on Capitol Hill have reached a consensus on the causes of the Congressional stalemate. This view, ably articulated by Senator Daniel P. Moynihan in a recent article in THE JOURNAL/THE INSTITUTE FOR SOCIOECONOMIC STUDIES[*] holds that comprehensive welfare reform requires so many trade-offs that no one is able to muster the political skill to fashion a compromise acceptable to a majority of the competing factions. Consider just two of the seemingly irreconcilable sets of conflicting goals: the demands of state officials for fiscal relief vs. those of advocates of higher benefit levels and the program designers' quest for administrative simplicity vs. effective mechanisms for reducing fraud and abuse. Compromise has proven impossible.

However, as difficult as it may be to shape a politically acceptable formula for revision of the welfare system, the real obstacle to change is more fundamental. The legislative log-jam is only a political overlay masking a basic policy dilemma that is the true source of the stalemate.

---

[*] Volume III, Number 1, Spring, 1978

A breakthrough in this policy conundrum may be in the offing, however. The revival of marginalist thinking in the public policy arena offers the promise of an Alexandrian sundering of the political Gordian knot. Sudden and unexpected Congressional support for the Steiger Amendment, which lowers the tax on income from capital gains, and the gathering momentum of the Kemp-Roth plan for a 30 percent cut in personal income tax rates indicate a renewed awareness of the power of government policies to shape individual behavior through incentives that influence decisions on the margin.

Former *Wall Street Journal* editorial writer Jude Wanniski succinctly described the marginalist perspective in a recent book bearing the modest title, *The Way the World Works:*

> *As a general rule of the economic model, the only way a government can increase production is by making work more attractive than non-work...The statement may seem childishly simple, but economists frequently argue that when individuals are taxed more they will work harder in order to attain a target level of income or wealth. These arguments can be supported by anecdotes, but cannot be true on the margin. If the person taxed works harder, then it follows that the person who receives the tax receipts works less, and there are thus neutral effects on income. All economists agree, though, that in addition to an "income" effect there is a "substitution" effect, and that clearly a worker substitutes leisure for work when his tax rate is raised.*

What remains to be pointed out is that this response to high marginal tax rates is not confined to upper income investors or upwardly mobile middle income citizens. There is little reason to believe that the poor respond to high marginal tax rates any differently than the wealthy.

The More You Tax, The Less You Get

Although the poor can in most instances fill out a Form 1040 and end up owing the IRS only a tiny percentage of their income — if they pay any tax at all — they are nevertheless subject to marginal tax rates that match or even exceed the marginal rates faced by our wealthiest citizens. The marginal tax rate faced by welfare recipients results from the combined effect of the benefit losses and income tax liabilities that they incur when they increase their non-welfare earnings. Under the current AFDC-Food Stamp program, many welfare recipients face a marginal tax rate of 70 percent or more. For every dollar gained through increased work effort, they lose 70 cents through reduced benefits or increased income tax liability. At certain income levels, the marginal rate under the AFDC-U program (for families that include an unemployed father) exceeds 100 percent — gaining a dollar through increased work effort leads to a net loss in total family income. Faced with these astoundingly high marginal tax rates, the welfare recipient has come forth with an outpouring of creative effort and ingenuity that matches or even surpasses the kaleidescope of tax-sheltered investments devised by the wealthy. The difficulty is that such "tax avoidance" by welfare recipients is uniformly counterproductive, for society as well as for the recipients themselves.

There is a saying that goes "the more you tax something, the less of it you get." Nothing could more aptly describe the effect of the high marginal tax rates of the existing welfare system on the work effort of welfare family heads. Nor is the impact limited to work effort alone. High marginal tax rates introduce perverse incentives that erode family stability, decrease parental responsibility, and encourage welfare fraud among the beneficiary population. In short, high marginal tax rates are the analytical key to understanding the whole range of problems associated with the welfare issue.

The reduction of work effort is undoubtedly the most obvious effect. A dramatic example is provided by the programs in which families with unemployed fathers receive benefits. Under such programs, earned income in excess of $360 per year is taxed at a rate of 67 percent up until the point at which the father works 100 hours per month or more — the equivalent of a half-time job. After that point, *the family is disqualified from further assistance payments altogether.* Due to this absurd provision, a family in which the male head chooses to accept a full-time job at the same wage rate as the prior half-time job will actually suffer a net *decrease* in take-home income once the loss of in-kind benefits such as Medicaid and food stamps is taken into account. No "culture of poverty" is necessary to explain why fathers of such families decline invitations for full-time employment. Confronted with this negative incentive on the margin, the male head of a welfare family will be as much of a "rational economic man" as any

Wall Street banker could possibly be.

The situation is equally grim for female family heads over many income ranges of the regular AFDC program. A welfare mother in my home state of Michigan who chooses to go from a half-time to a full-time job at $3.00 per hour stands to *reduce* family income by better than $47.00 per month — a marginal tax rate of 117 percent!

None of the proposals that have been before the Congress this year resolve this problem in a satisfactory manner. The incremental approaches, despite expansions of the earned income tax credit to a wider family income range, only reduce the marginal tax rate from the 70-100 percent range to a more modest 60-90 percent range for the majority of welfare recipients. The response of the wealthy to such tax rates is to shield their income from taxation through tax preferences, accounting gimmicks, and non-taxable compensation. Lacking these mechanisms, the only way the poor can shield income is to conceal it illegally or take it in the form of leisure or other non-measurable, non-taxable benefits.

The President can claim with some justice to have sought to end the work disincentive faced by welfare recipients at the lower end of the income scale. The problem with the Administration welfare reform plan was that it went after this goal by *broadening* the income range subject to the disincentive-producing high marginal tax rates of the present welfare system. In effect, the President proposed that we export these high marginal rates to the middle class.

The primary cause of the highly undesireable "export" was the exemption in the Administration plan of the first $3,800 in family income from the benefit reduction formula. Welfare parents who took jobs in the $5,000 to $6,000 range would, by the Administration plan, have experienced a small loss in benefits. But if family income rose above this modest level, the benefit reduction formula in the Carter Program for Better Jobs and Income (PBJI) would take the character of a sharply progressive tax rate schedule. Income in the range of $6,000 to $12,000 would be taxed at marginal rates in the range of 55 to 65 percent. Thus, while the first increments of additional family income would be protected from the high marginal rates of the current system, the work disincentive effect reappears with undiminished vigor a bit further up the income scale. When combined with other features of the President's plan, such as the expansion of the earned income tax credit and a new payment to offset taxes for low-income workers, the $3,800 disregard would have ensured that a larger share of American families than ever before would become subject to the work disincentives now reserved for the very poor.

The work disincentive is not the only adverse effect of high marginal tax rates, however. An equally acute problem is the strong financial incentive for the dissolution of nuclear families in our present system — an incentive that would have been perpetuated under the President's PBJI.

The clearest incentive for family break-up is well known. Under the present system, particularly in the states that do not offer a welfare program for families including both unemployed parents, a father who is uninterested in working can provide his family with an income of as much as $6,000 annually by the simple expedient of absenting himself from the home and thereby enabling his wife to qualify for AFDC benefits and associated in-kind transfers. The PBJI, which offered almost two times as much in benefits to single women with small children as it does to intact families, would have done little to reduce this incentive to family dissolution and fraud.

The incentive for family dissolution is not confined to families with unemployed fathers, however, nor is it confined in its effect to families that would in the absence of the incentive be close to breaking up. The very same powerful financial incentives act on families with fathers who *do* want to work and who may have moderately well-paying jobs. For example, the State of Michigan, through its AFDC program, pays a "bounty" of nearly $4,000 per year to each family that causes its $9,000-per-year father to disappear — officially — from the household. Although the notion that adult couples would be willing to maintain an informal or episodic living arrangement in order to qualify for AFDC and secure a net gain in family income of $4,000 may offend middle-class sensibilities, every welfare caseworker can attest to the pervasiveness of this practice among the welfare beneficiary population.

The high marginal tax rates of the means-tested welfare system also erode parental responsibility in homes in which the parents are legally separated. According to a comprehensive HEW survey of AFDC recipients, fully *83 percent* of absent or non-supporting fathers potentially had earning or child support paying ability; that is, they were not dead, incapacitated, or otherwise unavailable. Nevertheless, only *5.6 percent* were found to be subject to court-ordered child support payment obligations, and less than an additional four percent were providing support under a voluntary arrangement. Moreover, even the child support provided by this small fraction of fathers consisted primarily of token payments. *Half* of the court-ordered fathers were paying less than $75 per month — frequently less than $25 — and nearly *two-thirds* of those under voluntary arrangement were paying $75 or less.

In short, only five percent of potentially capable, but absent, fathers were making more than token payments for the support of their own children. Of course, not all of the 90 percent of absent fathers failing to provide child support are delinquent in the strict sense. Large numbers fall into the "officially" separated category described previously. To some unknown degree, their children benefit from the combined pool of shielded earnings and transfer payments available to the family.

In the case of genuine separations — which undoubtedly number in the millions — the legal machinery for enforcing child support obligations is nearly worthless. Under both the existing program and the alternative proposals that came before the Congress this year, *the tax rate on child support payments is 100 percent.* The deserted mother thus has absolutely no incentive to seek out the father or to cooperate with civil enforcement authorities and the courts. Any amounts retrieved go to recoup the state's welfare costs or result in a dollar-for-dollar reduction in her benefit entitlement. It is little wonder that so few errant fathers are ever brought to task for turning their child support responsibilities over to the public welfare administrator.

Perhaps the most serious failing of the welfare system we have today, at least in the public mind, is the substantial amount of fraud and abuse it engenders. The most common forms of recipient fraud are concealment or non-reporting of assets or income in order to establish eligibility for benefits at higher levels and failure to report changes in financial circumstances in order to maintain eligibility.

The extent of fraud and abuse under the current system is remarkable only in that it is not even more widespread. The high marginal tax rates of the current system have raised the stakes for concealing income to a level that can justify quite a bit of risk. And just as with the Internal Revenue Code, the effect of these high tax rates has led to the creation of a labyrinthine structure of definitions and distinctions for the determination of what is "taxable" — in the sense of resulting in benefit losses — income.

The average AFDC caseworker manual contains over 200 pages of text setting forth the distinctions between income that results in reduced benefits and income that has no effect on benefits. This mass of paper grows apace as the system tries to take cognizance of ever finer shades of definition in order to achieve some rough equity. It is little wonder that state AFDC programs require more than 100,000 employees just to make payment determinations.

The high marginal tax rates of the present system contribute to administrative complexity in another way by establishing a strong countervailing force to the stringent behavioral standards for employable welfare recipients that require maximum "work effort." Legions of caseworkers and investigators are needed to ensure compliance with the work effort standards; this should not come as a surprise in a system that rewards work effort by taxing away most of the resulting earnings.

The irony in all this is immense. We offer strong financial incentives to welfare recipients to shelter a few hundred dollars in earnings from tax by concealing them. Then, we pay welfare workers $15,000 per year to ferret out fraud and bring it to the attention of $30,000-per-year prosecuting attorneys. This can never be a winning proposition.

The "Iron Law of the Break-Even Point"

It would appear that the problems resulting from the high marginal tax rates of the present welfare system would be amenable to a simple solution. We could lower these high marginal rates to a level at which work disincentive and the encouragement of fraud and family break-up would disappear. But it would be necessary to bring the marginal rate to below 30 percent in order to produce any meaningful change — and that causes us to run into what may be called the "Iron Law of the Break-even Point."

The "Iron Law" is this: any system that establishes even a barely adequate minimum family or household benefit entitlement *requires* high marginal tax rates in order to keep the "break-even point" (the income level at which eligibility for public assistance would end) at a politically acceptable income level.

The following examples illustrate the operation of the Iron Law: if the minimum family benefit for a family of four is set at the near-poverty level of $6,000 and the marginal tax rate on earnings is kept to 25 percent, the break-even point is an annual income of $24,000. Under such a system more than two-thirds of all American families would receive some form of cash welfare payment! Even if the marginal tax rate is permitted to go up to 40 percent, the break-even point is nearly $15,000. This would include half of all families, a result that is no less politically unsalable than the first example.

Only a marginal tax rate of 70 percent or higher can lower the recipient population to a reasonable fraction of the total population. With the $6,000 benefit level, a 70 percent marginal rate yields a break-even point of $8,600 in annual income.

The incremental approach to welfare reform favored by the Carter plan sought to circumvent the operation of the Iron Law by placing a ceiling on income for entry into the welfare system that was below the break-even point for those already in the system. Thus, those who qualified for benefits by reason of an income below the threshold would retain benefits even after their income rose above the threshold. This permitted the imposition of a lower marginal tax rate on the efforts of welfare recipients to improve their earnings. This was only achieved, however, by dint of the serious inequity inherent in this device for restricting the eligible population to a reasonable level. Thus, two neighboring families might each have current incomes of $7,000. One would be receiving significant welfare benefits because its income had earlier been lower. The other would not qualify for any benefits.

Expedients such as this can ultimately offer little relief from the Iron Law. Inevitably the constraints of limited budgets make the adoption of low break-even points, with their companion high marginal tax rates, a necessity. The special House Subcommittee on Welfare Reform was forced to permit states that supplemented benefits above the Federal minimum level to raise the benefit reduction rate — the marginal tax rate for welfare recipients — from the 52 percent ceiling in the original Carter plan to 70 percent. Despite prodigious efforts, the Subcommittee was unable to free the basic means-tested welfare system from high marginal tax rates without raising the break-even point to an income level too high to be acceptable. Forced by the Iron Law to make a choice, they fell back upon high marginal rates.

A Radical Solution: Abolish Means-Tested Welfare

The preceding analysis suggests that the recent comprehensive welfare reform proposals are variants of a single unviable generic design: means-tested family entitlements. Even variants such as the negative income tax, which eliminate the problems associated with high marginal tax rates, suffer from other ailments arising out of their dependence on the means test. In the case of the negative income tax, for example, the complexity of determining eligibility and the incentives for concealment of income would be essentially the same as under the current system.

It is thus evident that the only real solution to the problems of means-tested welfare for the working or work-eligible population is to simply do away with it. "Welfare" as we know it should be abolished for all but the non-working — the aged, blind, and disabled — whose eligibility can be ascertained by reference to physical characteristics.

This leaves us with some fundamental questions, however. Do we as a nation want some kind of transfer payment program for the working population. If so, how should such a system be structured?

Judging by the high level of government resources currently committed to income transfer programs, and the consistent efforts of the Federal government to expand coverage under these programs, it is clear that there is an implicit consensus that transfer payments are appropriate for those with inadequate incomes.

Just as clearly, there appears to be a consensus that this policy derives first and foremost from our desire to protect children. Ensuring adequate income support for children is the focus of the AFDC program, as well as the original guiding principle behind the establishment of the personal exemption in the Internal Revenue Code. Unlike the many tax preferences subsequently added to the Code in lieu of reductions in the high marginal rates of the personal income tax, the personal exemption was never a backdoor means of lowering marginal tax rates. It was a Federal commitment to adequate resources for raising children.

The effective support level provided by the combination of the transfer payment programs and the personal exemption varies, however, by income. The high marginal tax rates associated with the transfer payments quickly reduces the level of public support for each child, which is restored only very slowly as rising marginal personal income tax rates increase the value of the personal exemption. By putting in place a system of universal child payments, we could satisfy this fundamental desire of society to provide for the support of children, while simultaneously doing away with the problems associated with the means-tested welfare system. The universal child payment system would eliminate all of the problems associated with high marginal tax rates, since no change in income status would affect eligibility. It would eliminate all the administrative complexity of existing welfare programs, since the only determination necessary would be to identify the proper recipient for each child. Because it would replace both our existing AFDC transfer payment system and the personal exemption in the tax code, the net cost of a universal child benefit system could actually be less than the cost of the existing system.

In addition to the implicit desire to provide for children evident from our existing welfare and tax policies, there are other major policies in favor of income transfer that indicate that our society is not content to allow the market to allocate income without offering some buffer. First, there are explicit transfer payment programs, directed at adults whose income falls below certain levels, such as food stamps and AFDU-U. More significant, there is the policy of redistribution implicit in the minimum wage laws, which prevents the market from valuing labor services below a level that provides a certain level of income with the intent of effecting a transfer of income within the market structure.

In combination, the overt transfer payment programs and the minimum wage laws have had devastating effects. The marginal tax rates of the overt programs result in tremendous work disincentives and the withdrawal of labor from the market. The minimum wage results in the foreclosing of job opportunities by preventing employers from hiring workers whose productivity cannot support a wage at the minimum statutory level.

Any program to repair or replace the existing benefit programs for adults will of necessity contain an element of income transfer.

Perhaps the most likely candidate for a new mechanism for distributing benefits is some form of wage supplements implemented through a negative income tax withholding structure for low-wage workers.

A tax credit of perhaps 20 percent of gross wages earned, provided to low-wage workers immediately through a negative withholding tax, and phased down to allow positive taxes only at a level above the normal entry level wages for unskilled and semi-skilled jobs, would have a strong work incentive effect. Such a system would, like the universal child payment, have many advantages. The system would impose a negative marginal tax rate at the lowest ranges of the wage scale, giving very strong work incentives, while simultaneously encouraging the largest possible number of workers to participate in the taxable labor market. The importance of drawing workers out of the underground labor market, in which transactions escape all taxation through the use of cash or barter arrangements, cannot be overstated. Some economists have estimated the total annual value of goods and services in the underground or black market at $100 billion.

The negative withholding system would also enable us to put a freeze on the minimum wage. This would in time significantly expand labor market opportunities for low-wage workers, without sacrificing society's desire to see that every worker disposes of some minimum level of income.

Because the negative withholding system would attach to the workers and not to the family unit, it would encourage more than one family member to enter the labor market. It would actually be to the advantage of the family to have two workers with nominal wages of $3.00 per hour instead of one worker earning $6.00 per hour. The increased labor market attachment for low income families that this would produce would improve their ability to weather job losses by individual family members. A related positive aspect of the negative withholding system would be its complete neutrality in affecting family behavior, since family status would be irrelevant to eligibility.

The most attractive alternatives for welfare reform available to us thus take cognizance of the plain fact of the matter: means-tested welfare is unworkable and harmful. By moving to systems such as the universal child payment and negative withholding, we can shape incentives at the margin that lead to higher labor output, greater family stability, and a lesser burden on the economy as a whole, while still meeting the unstated but implicit policy goals of providing a minimum standard of living for those who cannot achieve it without some form of assistance.

The **Chairman**. We do follow the early bird rule, but Senator Long is here. Do you have any statements you want to to make, Senator Long?

Senator **Long**. I will take my turn when it comes, Mr. Chairman. Thank you.

The **Chairman**. Senator Byrd.

Senator **Byrd**. Thank you, Mr. Chairman.

Mr. Stockman, you and the administration receive some criticism from time to time. It seems to be increasing in intensity recently. I have not joined in that for this reason: I feel that this administration and you have attempted to do more about controlling the increase in the cost of Government than any previous administration. I commend you for your work in that direction.

Now I think the great problem is this question of deficits. Everyone has different figures as to what the deficits will be. I think you have underestimated the deficits for the next 3 to 4 years. I think CBO has probably overestimated them. But in my judgment, they will run $100 billion a year for 3 to 4 years.

Now my question to you is this: Without getting into an argument as to whether the $100 billion is exactly the figure that it will be, assume that we run $100 billion deficits for 3 to 4 years, can this country survive by running such huge deficits over a 3 to 4 year period?

Mr. **Stockman**. Well, Senator Byrd, I think in some basic sense we could survive, but I believe the burden on the economy would be enormous. The effect on interest rates would be unacceptable. The prospects for sustaining a permanent recovery rather than simply a temporary recovery would not be high, and for that reason, I would come to the conclusion that as a basic policy matter, $100 billion deficits, back to back, year after year, in a period in which we expect strong recovery and revival of our economy, simply isn't a compatible prospect.

Senator **Byrd**. I certainly agree. And it appears to me that the country and the business community not only agrees with that—what you just said—but assumes that that is going to take place or something approaching it. Do you agree that there's a lack of confidence on the part of the public in the business community as to what will actually take place in regard to deficits in the next 3 to 4 years?

Mr. **Stockman**. Senator, I agree with that. But I don't believe it's a lack of confidence in the program. I believe it's a lack of confidence in the capacity of the executive branch and the legislative branch to jointly work together to implement the additional budget restraint and revenue increases necessary to bring the deficit down below the recession peak and keep it moving on a credible genuine path toward balance over a period of time. The way to restore confidence is to prove the cynics are wrong, and that despite all of the pressures and the temptations to politicize issues under the current environment, the administration and the Congress working together can fix into law those basic changes that we need to insure that the deficit does not break the $100 billion barrier that you have talked about, and moves steadily down as the recovery gathers momentum in the outyears.

Senator BYRD. I agree with you. And I think it is essential that the Congress and the President work together to do just that.

Now let me ask you this: What is the debt now, subject to limitation? And when will that ceiling be breached?

Mr. STOCKMAN. Senator, I believe the current figure is $1.08 trillion. And the expectation is that sometime later, we would need an increase in the debt due to these higher deficit costs for 1982 that I have described. Treasury is currently working on a detailed scrub to pinpoint precisely when that date would be or that period of time. I am sure that they will be providing that information to this committee and the Ways and Means Committee at the earliest possible date.

Senator BYRD. I assume that you anticipate it will be well before the September 30 date, at which the level has now been set?

Mr. STOCKMAN. That would be correct, Senator.

Senator BYRD. Now you stated in your opening comments that it would take serious treatment of budget deficits to lower interest rates. Now could you amplify that? What do you mean by "serious treatment of budget deficits?" And to what degree do the budget deficits need to be reduced to bring about a lower interest rate?

Mr. STOCKMAN. Senator, I think everyone has tried to find a magic number as to what the deficits can be or what level would be tolerable or compatible with declining interest rates and sustained recovery. I don't think there is any magic number or scientific answer. But I do believe that it's important the deficit not exceed the recession peak of $100 billion or so in 1982, as we move into a recovery in fiscal years 1983–84. We must come below $100 billion, and the more we can come below it, the better.

Second, I believe that an outyear path of deficits that is steadily declining is essential to restoring confidence in the financial market. It seems to me the problem at the present time is in the bond market; it's in the long end of the market. That market is saying that the current inflation rate has dropped from 12 to 5 percent, but the permanent expectation of inflation is still in the double digit range. I think the reason the markets have maintained that view—that the permanent inflation expectation is double digit even though the current inflation rate is at 5 percent—is simply the belief that these deficits will not be reduced, and that sooner or later the Fed will be asked to print the money to pay for them. We would the be off to the races again in terms of excessive rates of money growth and inflationary pressures building in the economy.

It seems to me that once it has been demonstrated that we have incorporated into law those entitlement, revenue, and other fiscal disciplines that are needed to remove these prospective deficits, the inflation expectation can change quickly and dramatically permitting a revival of the long-term bond market. That, of course, will begin to create a financial environment in which strong economic recovery is possible. Thus, the restoration of confidence in the financial market is all linked to our ability, in some basic sense, to deal with the projected deficits in the outyears.

Senator BYRD. Just one concluding comment, if I may, Mr. Chairman. I agree with what you say there. I don't share the optimism which you appear to have that it will be accomplished. And I'm not encouraged, I must say, by your assertion that the budget deficit must not exceed $100 or so billion. It seems to me that is taking a pretty cavalier look at the deficits. Thank you.

The **CHAIRMAN**. Senator Heinz.

Senator **HEINZ**. Thank you, Mr. Chairman. Let's see if I have some numbers right. As I understand our fiscal situation, according to the Congressional Budget Office, if we don't do any of the budget cuts that the President has proposed—if we don't enact any of them or any alternatives to them, if we don't do any of the revenue enhancement the President has proposed—looking at both the on and off budget deficit, we would have a deficit of $176 billion in fiscal 1983, $206 the year after, and $226 in fiscal 1985. Those are the CBO numbers. They add up to $608 billion on top of the existing $1 trillion national debt. A 60 percent increase in just 3 years if we do nothing at all. Does that sound about right?

Mr. **STOCKMAN**. Senator, with the CBO economic assumptions, those numbers sound correct to me. Ours are slightly lower with a different set of economic assumptions. But, basically, I think you can say that the cost of stalemate, of nonaction, of sitting on our hands over the 3 years in the budget period before us, is in the range of a half trillion dollars or better.

Senator **HEINZ**. So doing nothing is unacceptable. We understand that. It would probably drive interest rates up even further if we did nothing.

Mr. **STOCKMAN**. That's correct.

Senator **HEINZ**. Under the CBO reestimates of the Reagan administration budget, the comparable numbers are $137 billion in 1983, $144 billion in 1984, $152 billion in 1985. That totals $433 billion in additional national debts. And that's if we did, according to the Congressional Budget Office, everything, everything that President Reagan has asked the Congress to do. That is a higher number than the OMB estimates. OMB would come up with a number, oh, about $130 billion less in deficits than that $433 billion, as I understand the numbers.

If you were a Member of Congress again, and if you believed that CBO was right rather than the Office of Management and Budget—and I realize that is an extraordinary leap of faith to ask of you at this time. But it is not so extraordinary for us. Would you, seeing $433 billion worth of additional deficit if we did everything but nothing more than the President proposed—would you vote any increase in the debt ceiling bill when it came up unless and until you got a far better resolution of the budget? Would you vote for an increase in the debt ceiling bill if you saw those kinds of numbers facing you?

Mr. **STOCKMAN**. Well, Senator, I think I would have to say that if I were still a Member of Congress I probably wouldn't believe either set of numbers, CBO's or OMB's. But I do have to take some objection to the CBO reestimates. I think that rather dramatically overstates the picture.

Senator **HEINZ**. Let me not contest that with you.

Mr. **STOCKMAN**. But I will say on the specific legislative question that you have raised, I don't believe that I would have voted any increase. I voted against debt ceiling increases consistently when I was in the Congress. I think that I would want to see, as part of that debt ceiling increase, some major treatment of the problem in the sense of serious, credible, forceful action to reduce the prospective deficit path.

Senator **Heinz**. I totally agree. Thank you, sir.

The **Chairman**. Senator Roth.

Senator **Roth**. Mr. Stockman, I, like you, tend not to believe either CBO or OMB. Not because I don't basically trust either one, but frankly I think too much reliance is placed on these forecasts. And this concerns me very greatly. For example, Alice Rivlin, in an article written in March/April of 1981 points out that the big problem is not diversity of forecast at any one moment, but the fact that during time the forecasters are likely to change their minds. What concerns me is that these predictions, these guesstimates for 1983—not so much 1983—but 1984, 1985, 1986 are guesstimates. They do depend upon the assumptions made in the model. And yet I am fearful that by constantly emphasizing the negative, the deficits, which are extraordinarily serious, we are almost creating a self-fulfilling promise. Mr. Roosevelt said many years ago that the only thing we need to fear is fear. All we are hearing now is gloom and doom. And we forget that the basic purpose of the President's Economic Act is to promote real growth.

Now I would ask you: Are these numbers ones that we can rely on? Or are they going to be constantly subject to change? These forecasts.

Mr. **Stockman**. Well, Senator, I would say two things. It's almost unavoidable and inevitable that these forecasts are subject to change. Let me give you one example. We had to lock up the budget numbers in December for the Commodity Credit Corporation. We did not have access to more complete and newer information on the size of the wheat crop and the prospective wheat price, the size of the corn crop and so forth. In February, when more complete information was available, USDA reestimated fiscal year 1983 outlays from $2 to $7 billion. And those kinds of things constantly happen because in many areas of the budget you are dealing with a very fluid situation.

The second point I would make is that if you look at the historic record, both OMB and CBO have consistently estimated the deficit wrong. You are precisely correct on that. But the further point I would make is that the error has always been on the under side. It is almost always underestimated whether by Republican, Democratic, congressional, or executive branch sources, because, obviously, we have a tendency to hope and expect the best.

The third point I would make is that these deficit numbers that we are dealing with are the minimum that we can expect because the administration's forecast is based on the most rapid economic growth rate we can expect; the most rapid fall in the inflation rate we can expect; and the most rapid decline in the interest rate that we can expect. If there are likely to be any changes, they will most probably be in an adverse direction. We are assuming an average real economic growth rate of nearly 5 percent over the next 5 years, that exceeds more than 75 percent of historical experience, on average, since World War II. If you look at this forecast, you will have to realize that there is no way to make the problem easier or smaller by assuming a better performance of the economy.

Senator ROTH. That, basically, is not my point. My concern is that we seem to be relying upon these forecasts which are nothing but predictions based upon a certain economic assumption. And I think it is a mistake. And I'm not being critical of either your outfit or the one here. But they are only as good as the basic assumption.

Let me ask you a second question. I, for one, am a strong believer that defense cannot be increased as rapidly as the administration is proposing. I just make that comment because I think it is important to understand that back home, there is not the kind of support for the tremendous 18-percent growth that has been proposed. It seems to me that one of the things that the administration is going to have to look at, and the Pentagon in particular, is a setting of priorities in that area. It seems to me that a real 7-percent growth instead of 10 percent, as projected, is perhaps more realistic. But I would urge you to spend some time and energy, and the people in the executive branch, to force priorities to be set in that part of the budget as well.

Thank you.

The CHAIRMAN. I believe I am next. First, Dave, I want to say how much we appreciate your efforts in the past year and a half—not quite a year and a half. I think you contributed to our moving in the right direction. Having said that, I think most of us on both sides believe that we must do something more. There is a difference of opinion on what we we must do. Some may not really want to do anything but talk of it. But I think for the most part, most Republicans and Democrats understand the necessity of doing something. The question is how much time do we have? Do we have 30 days, 6 weeks, 2 months? The debt ceiling extension hearings will probably be in late April. It should be on the Senate floor in May. Is that too late to use the debt ceiling as a vehicle for some package if we can put it together?

Mr. STOCKMAN. Well, Senator, that gets into the realm of legislative tactics, which you would be more expert at than me. I would only say from the point of view of economics, given the lags in the budget, that if you are going to make major changes for fiscal year 1983 that will reduce the deficit on the revenue side or the entitlement side, the earlier those changes are enacted into law the better. As we learned last year, 3, 4, or 5 months to implement changes on the entitlement side because you need hearings, regulations, field level implementation, and so forth. Revenue changes can't be implemented immediately either.

Second, I believe that over the next month or so, we will have a window of relative calm, hopefully, in the financial markets. The money supply is coming back onto track and Federal borrowing in the first half of the year has been below expectations—that will catch up later. So it seems to me that if we want to build on that progress that has been made since the middle of February—as we have seen money market conditions and the short rates come down 200 or 300 basis points and the prime rates start to ease—it would be a critically important signal to the financial markets to get these permanent changes in place sometime in that window. Such action would lessen the risk or the probability of a reversal of the favorable trend that is underway now. And, of course, if we can keep that trend going, the prospects for an earlier and stronger and more sustained recovery will be improved, I think, substantially.

The **CHAIRMAN**. Well, as you know, there are a number of Republicans and I understand also a number of Democrats meeting on whether or not we can agree on some change to present to the President at the appropriate time. I think many of us left the meeting yesterday with an indication that the President is willing to listen. He didn't suggest that he was going to change any policy. But I think there was a feeling that he was receptive and that gave us encouragement as we continue our meetings. They must become bipartisan if they are going to succeed. We are looking at areas in this committee such as medicare, medicaid. I believe, particularly in the medicare side—maybe more than medicaid—that there is room for substantial reduction. There's a program that is almost out of control, if you look at the growth over the past 10 or 12 years. As you have indicated, if we can't agree on what you propose in the budget, then if we must find some other way to achieve that savings or more. That is not really a problem as far as you are concerned.

Mr. **STOCKMAN**. That would be the case, Mr. Chairman. But I also think that if you examine very carefully the detailed changes, say, in the medicare area you are discussing, you will find that many of them have great merit, are justifiable, and ought to be considered very carefully by this committee.

As we took a hard look at medicare, we concluded there were many provisions of a detailed and sort of microcharacter, that can be changed without harm to beneficiaries and without great dislocation to the provider system.

Let me offer one example or two examples of the kinds of things we think should be done. When medicare was established, uncovered services were deemed reimbursable because there was a feeling it would take some time for providers to become accustomed to the rules as to coverage. That rule is still there, it is viscidual, it ought to be eliminated.

We have a dual treatment now in physician reimbursement. Where most physicians are reimbursed at 80 percent of reasonable and customary costs, hospital based physicians—radiologists and so forth—are reimbursed at 100 percent. There is no strong justification for that differential treatment and it does lead to excess cost.

We have anomalous situations where physicians are appropriately reimbursed for their overhead costs when they practice in the clinic or the office, but receive the same reimbursement rate if they treat a patient in the outpatient ward of the hospital.

In that latter circumstance, they are not paying the cost; the hospital is. Yet, they are being reimbursed under overall aggregate reimbursement for basic cost under medicare.

That kind of situation should be remedied by a lower rate of reimbursement for outpatient, clinic based services.

I think as you go through this list, you will find a lot of changes of this type that can be done. While they are small individually, these changes add up to the magnitude of savings that we will need if we are to bring this growth of medicare down.

The final point I would make, though, is that these kinds of changes are only helpful on the margin. If we are to deal with the basic growth and cost growth of medicare, which will be $99 billion by 1985, we are going to have to initiate to reimbursement reform, and delivery system reform of some fundamental character. We are working on that in conjunction with our consumer choice procompetition legislation that we will be forwarding to this committee later.

The **Chairman**. Senator Symms.

Senator **Symms**. Thank you, Mr. Chairman.

And, Mr. Director, welcome to the committee this morning. On page 8 of your testimony, you have the chart where you have the entitlements as a share of the budget. It starts out in 1955 as 19 percent of the budget, 1965, 27 percent, 1975, 45 percent, 1981, 46.5 percent. Do you have those numbers of what is projected for 1982 and 1983?

Mr. **Stockman**. Yes, Senator, we can provide those for the record.

[The information follows:]

ENTITLEMENT

[Dollars in millions]

	1982	1983
Outlays	$339,957	$357,925
As percent of the budget	46.9	47.2

Mr. **Stockman**. I believe as a result of the changes last year, the percentage share would not increase very much at all. It would be in the high 40-percent range. But we will provide those precise numbers to you.

Senator **Symms**. I hear other Senators make comments that at the present rate of growth of entitlement programs that by 1990, the entitlement programs would consume 90 percent plus of the budget. Does that sound accurate to you?

Mr. **Stockman**. I think that requires a number of assumptions. It depends on how big you think the budget will be in 1990, and what the tax policy will be. And what may or may not be done by way of policy change on the entitlements. I think that is too high. I did, though, provide a projection in my testimony in which I said if the 15 percent annual rate of growth in entitlements that prevailed through the entire 1970's had been maintained in the 1980's, then by 1986, we would be spending well over $600 billion on entitlements alone. So although the 90-percent number is clearly high, the trend and the message that you are trying to get at there is basically correct.

Senator **Symms**. Well, I guess that the problem that we are confronted with is there is a great hue and cry often times when we have problems with the budget—you hear the hue and cry, well, cut defense, cut defense. But if we cut money out of defense, do you think it would have the impact on the financial markets that a real reform of entitlements would have that would last on into the future?

Mr. STOCKMAN. I don't believe it would have the same impact because, clearly, the financial markets are concerned about the permanent automatic growth pressures in the Federal budget. If you were simply to defer military spending for a year or two, it would not have, I think, the same effect. But more importantly, I don't believe the financial markets are looking for defense outlays or for discretionary outlays or for highway outlays in particular, one in preference to another. I think they are looking for a reduction in aggregate outlays from whatever appropriate source so that the financing and current borrowing requirements of the Government will steadily come down.

Senator SYMMS. Since you mentioned highway outlays, I will ask you another question on that. Secretary Lewis exploded a trial balloon for an increase in the Federal gasoline tax of 5 cents a gallon. If that would happen to come to pass, what would your attitude be about spending that money out of the trust fund?

Mr. STOCKMAN. Well, that proposal is being reviewed at the present time so I wouldn't comment on its substance. In terms of your latter question, though, obviously, if it is collected for highway use and put into the trust fund, then it ought to be spent for the authorized purposes for which the trust fund was created.

Senator SYMMS. Well, I am glad to have you on record saying that, Dave. I imagine you and I will be discussing that more. I am very concerned about that point. I think when people look at places to where the Federal Government could raise revenue, they always look at the Federal gas tax. And that is probably one of the best Federal programs that is on the books. But it always seems like it is a very difficult problem to get the money back out of the trust fund once you get it in there. I think the trust fund carries a balance of some $8 billion. And I guess in the unified budget, that helps you make the budget——

Mr. STOCKMAN. Could I respond to that, Senator?

Senator SYMMS. Certainly.

Mr. STOCKMAN. We constantly hear that there is an accumulated balance of $8 billion. But on a current cash flow basis—that is, does the Highway Trust Fund add or subtract to the deficit in 1983 or 1984—my recollection is that it is almost a wash. We are not getting any reduction in the current year deficit as a result of current year surpluses coming into the fund. Those surpluses were achieved in the past, and they haven't been entirely drawn down.

Senator SYMMS. You are correct about that. But I think that you have called for slightly less—half a billion dollars less than—your recommendation is about 7.7. I think the committee recommended about 8.2. And for the committee recommendation, I think that certainly is correct.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bentsen.

Senator BENTSEN. Mr. Chairman, I was listening a while ago to Senator Roth reminding us of Franklin Roosevelt's famous quote that all we have to fear is fear itself. I'm told today that fear comes in fourth. Think about that one for a while.

Mr. Director, you stated last year that the best indicator of the success of your program would be the behavior of the financial markets. To quote specifically, you said, "I'll watch which direction the long-term rate is going as my guide as to whether or not we are succeeding."

Mr. Director, those rates have not declined. The interest rates on 3- and 10-year Treasury bonds are at an almost alltime high, while the long-term capital markets virtually don't exist. My concern is that what you are proposing this time doesn't go far enough to impress the financial markets. I would like for you to comment on that.

Mr. **STOCKMAN**. Senator, I think it is hard to put a quantitative judgment on it. How much would it take to convince the markets that inflation isn't down temporarily but permanently? That large permanent deficits will not be realized. That we are not running the high risk of monitizing the debt at some time down the road. I think we can come to some rough conclusion that certainly triple digit deficits aren't compatible with any appreciable reduction in the long-term bond rate. The quicker and faster we can reduce the deficit below the triple digit level—that we will inevitably suffer in this recession year—the better response we probably will expect to achieve in terms of the long-term rate reduction and the revival of long-term capital markets that we need. But I don't know that anybody has an equation that will tell you that for every $10 billion reduction of the deficit you are going to get a half point on the bond price. I don't think that kind of thing exists.

Senator **BENTSEN**. Nor do I.

Mr. **STOCKMAN**. But I think we do know the general direction and the more we can do without violating other important objections that are also important for the economy, the better off we will be.

Senator **BENTSEN**. Mr. Director, I think the point you made earlier about what we have to show in the outyears is very important. I think we have to show that there will be a substantial reduction in the deficit in the outyears. That is what will impress the financial markets. To accomplish that one of those things that we will have to consider is what we do about the tax system itself. The deferral of the third year tax reduction is one of those options. Safe harbor leasing is another provision that we will have to substantially limit to reach the objective.

But I would like to talk to you about one program specifically—the work incentive program. According to the figures of the Department of Labor—which I cited to the Secretary of Health and Human Services yesterday—this program resulted in net savings of $700 million from 1976 through 1981. I don't see why we should abandon a cost-effective program that helps put people back to work, and gets them off of the welfare rolls, and turn it back to the States with no assurance that it is going to be carried on there. Would you comment on that?

Mr. **STOCKMAN**. I would make two comments, Senator. I think for more detail you would have to go back to HHS. But two points. One, we have proposed to replace it with a mandatory community work experience program so that the same people who are involved in the WIN program today presumably would be covered by that.

Second, I see these cost-benefit studies of Federal programs constantly and I am highly skeptical about most of the results.

Senator **Bentsen**. That study came out of your administration. Those are the Department of Labor's figures.

Mr. **Stockman**. Well, I have been skeptical of their figures as well as the figures from all the other departments who have come in asking for money that we can't afford to spend. But in this case, as you would appreciate, it requires a whole variety of assumptions about whether people would be on the rolls absent the WIN program, whether they would have graduated sooner rather than later, and what their wage rate would have been absent WIN versus with WIN. If you set up the right assumptions, you will get the answer that you have given, but I am not sure that those assumptions can be fully defended.

But my more important point is that the community work experience program will functionally achieve the same thing of reducing from the dependency rolls those who are work capable and capable of supporting themselves.

Senator **Bentsen**. Thank you, Mr. Chairman.

The **Chairman**. Senator Baucus.

Senator **Baucus**. Thank you, Mr. Chairman.

Mr. Director, not long ago when advocating last year's budget proposals, you said that the administration is interested in and—I will quote you here, "Interested in curtailing weak claims rather than weak clients." And continuing your quote, "We have to show that we are willing to attack powerful clients with weak claims."

In light of those statements, I would just like to review some features of this year's budget. One, along the lines of Senator Bentsen, the WIN program. It seems to me that's a program where it is very cost effective and those tend to be weak clients. That is, not powerful clients. And they also tend to have powerful claims.

The second area is in respect to the medicare cuts. Secretary Schweiker, yesterday, presented us with a chart showing the administration's view that the medicare beneficiaries are receiving only 9 percent of the cuts; hospitals, physicians, and others receiving a greater share. The fact of the matter is that I don't think anybody on this committee believes that medicare beneficiaries only receive 9 percent of the cuts. Ultimately, they are going to be receiving much more of the burden there.

And Senator Moynihan, yesterday, also pointed out how working welfare mothers are being cut back drastically by this administration's budget proposals.

Then we have the strong client. That is, the strong clients with weaker claims. And that's the defense budget. To me, that seems to be a very strong client. And there is also great political strength in the entitlement program.

My question is: If the budget is in such rotten shape—and I agree with you that it is. We have these big deficits, and a very adverse effect on interest rates—why isn't the administration spending more time with bigger items? For example, you yourself once stated that there is about a $10 to $30 billion swamp in the defense budget. That can be cut back. That amount. Why don't we spend time addressing the big ticket items? And why doesn't the administration spend time addressing the big ticket items, defense and entitlement, more directly instead of trying to cut back from benefits to weaker clients but who have stronger claims?

Mr. **Stockman**. Senator, let me respond to that question with three points. One, I do not consider the Defense Department an interest group client. I consider the defense budget a fundamental requirement to the security of this country. The funding levels and the rate of buildup over which we can argue——

Senator **Bentsen**. We all do.

Mr. **Stockman**. Second, I would point out that we made a substantial run last year at curtailing the budgetary claims of weak clients. Without trying to be devisive about this, I must point out that in case after case the Congress, in its wisdom, decided that those strong clients had stronger claims than we thought by increasing the Export/Import Bank substantially; by continuing energy subsidy projects like SRC-1; by funding some water projects that we felt really weren't essential at this time; and by refusing to cut the dairy price support program to curtail the cost at least to a level under $700 million. You can go on down the line and I think you can demonstrate that we consistently tried to implement that principle. We were successful in many cases; not in others.

Third, on the entitlements, I think you are talking about social security because we have tried to endeavor to reform every other entitlement program. Social security is now pending before the Bipartisan Commission, of which Senator Moynihan is a member. I don't think you are dealing there with something as simple as weak or strong clients or claims. You are dealing with inner generational promises that have been made for social insurance benefits.

Now on the matter of COLA's, we have proposed reform for nonsocial security COLA's; that's one item that you are raising here. The President has said that he would consider a broader reform if it were proposed and supported on a bipartisan basis.

The point I am making is that the charge that we have simply cut weak clients rather than weak claims is not very valid if you consider the whole range of proposals that we have made or have enacted.

Senator **Baucus**. But won't you agree, though, that these human services program cuts are cuts addressed to weaker clients? And that's contrary to your stated goal.

Mr. **Stockman**. I don't think I would say that as an unequivocal abstract principle because in some places they simply were not effectively run or they were duplicative of other programs.

Senator **Baucus**. Let me ask one short question here. And that is, when will your competition, health legislation, be before the Congress? When are you going to present that to the Congress?

Mr. **Stockman**. Well, I believe that that is being considered at a meeting within the administration today. And that some time in the relatively near future legislation——

Senator **Baucus**. Weeks, months? Could you give us an idea?

Mr. **Stockman**. I couldn't tell you in terms of weeks or months. But our goal would be to get it to the Hill sometime later this spring.

Senator **Baucus**. Thank you.

The **Chairman**. Senator Mitchell.

Senator **Mitchell**. Thank you, Mr. Chairman.

Mr. Stockman, just a few minutes ago in your opening remarks you said, referring to medicare and medicaid, without seriously addressing those areas, we can't solve the problem. There are some of us who feel that that applies directly to the defense budget, as Senator Baucus has suggested in his questioning. He referred to your earlier statements. I have them here and I would like to read them and ask you a series of questions about them. This is a direct quotation by you in the Atlantic Monthly:

> As soon as we get past this first phase in the process, I am really going to go after the Pentagon. The whole question is blatant inefficiency, poor deployment of band power, contracting idiocy. Hell, I think there's a kind of swamp of $10 to $20 to $30 billion worth of waste that can be ferreted out if you really push hard.

The first question is did you say that?

Mr. STOCKMAN. Well, my answer is yes.

Senator MITCHELL. Thank you. My second question is did you believe it when you said it?

Mr. STOCKMAN. Still do.

Senator MITCHELL. You still do?

Mr. STOCKMAN. And I believe we've found a good deal of it. As you know, Secretary Weinberger has presented to the Congress the result of steps they've taken thus far which will reduce, purely on management efficiency waste areas, $20 billion from otherwise required defense spending over the next 5 years. Now that's dead center in the middle of the swamp I was talking about. So I think we are making some progress. There is more that can be done.

Senator MITCHELL. Well, some of us are a little bit skeptical about that. But we wait hopefully that it will occur. But my question is, I don't feel that you really have gone after the Pentagon. And I don't see how you can in good conscience come here and tell us we have to cut medicare; we have to cut medicaid while you are presenting a budget that calls for just enormous increases in defense spending, following on an enormous increase last year.

Now we all want a strong defense. And we are all talking about increasing defense spending. The only question is the rate of increase of defense spending. And I just don't see how you, in good conscience, believing what you now say you believe, can come here and urge us to cut medicare; to cut medicaid, grind down those at the bottom end of the scale while this defense budget really is going unscathed.

Mr. STOCKMAN. Well, Senator, I don't see how we can determine the level of budget resources we need for national security based on how much we spend or don't spend on medicare. I think they are entirely independent or separate questions. We can make judgments—and I know you have a different judgment—on what is needed in the pace of buildup. That's a legitimate argument and I am sure it will be solved by Congress this year. But we can't get back to the business of simply saying that there are two sectors in the budget—human resources and defense—and we think there is too little in one and too much in the other and we are going to trade it around. That's no way to make a defense policy. We did it in the last decade with very adverse and very ominous results for this country. I hope that even as we debate the defense issue, we do it on demonstrated security requirements, demonstrated military objectives, and demonstrated needs for investment both in weapons and readiness, and make the proper call.

Senator MITCHELL. Well, it's a single budget. It is really a setting of priorities. And what I am saying to you is that the human needs of the elderly and the poor of this country and all of the people of this country are just as important to this Nation's security as are strategic missiles and other forms of military things. That's not to denegrate the necessity of the latter. But every society in human history has been powered by human will and resolve of the strength of the people. And machines, equipment are only as good as the underlying strength of the society which supports them.

Mr. STOCKMAN. Senator, I agree with that, but I must point out that even after the cuts that you are objecting to here, we will spend $72 billion on medicare and medicaid in 1983. That's more than we are spending for strategic weapons, for ships, planes, tanks, for all procurement practically in the Federal budget.

Senator MITCHELL. You say that as though that is wrong.

Mr. STOCKMAN. No, I don't. I say that to suggest that if we can't meet the needs of the elderly and the low income on a $72 billion budget by doing it better in terms of reimbursement, in terms of eligibility, in terms of administrative costs, then we have failed as policymakers to make use of the ample resources that we have allocated to that purpose. I think the $72 billion isn't the problem, it's how we can spend it more efficiently. I would invite you and other members of this committee to help us figure out why we only spent $14 billion for that purpose one decade ago.

Senator MITCHELL. We will be glad to do it. Can I make just one closing comment, Mr. Chairman? Very brief.

The CHAIRMAN. Certainly.

Senator MITCHELL. I commend the chairman for his efforts to produce a bipartisan compromise. He talked about it earlier today. His exact words were, "it must become bipartisan." There must be a joint effort by Democrats and Republicans in Congress to produce a budget that does something about the problem which I believe the administration's budget does not. But I just wanted to say to you as one Democrat that there is not going to be a bipartisan compromise if one side doesn't want to compromise. And as long as the President goes around the country attacking in the most partisan shrill manner any Democrat who happens to disagree with him, there isn't going to be a compromise. And to go out West and conduct highly partisan campaigns and to say this doesn't apply to any Republicans, it applies only to Democrats. But then to have the chairman say we have got to get Democrats in on this package. I think you ought to urge the President to tone down his rhetoric. We all want to do what is right for this country. We want to have a budget, but it takes two to compromise. And the only way we are going to compromise is to set the tone to do it. And the tone is not now being set by the President.

The CHAIRMAN. Senator Long.

Senator LONG. Mr. Stockman, since reference was made to the Atlantic Monthly article, I want to comment on that. I've heard what you said about the matter. That the article was at variance with the press account. And I would be the first to agree that that was the case. And having read both, I found myself thinking that the only thing that is really wrong with the article is that it was published prematurely. If it had been published at a much later date, let's say at a time when you had gone on your way into some other endeavor, it not only would mark you as a very wise man, but perhaps the hero of this administration. It may yet before it is over with. [Laughter.]

I find nothing wrong with what you said in that Atlantic Monthly article, reading the whole article in context. And I think I am also rather familiar with what your views are with regard to the overall problem. May I say that I think I understand some of that. I once worked as the executive counsel for the Governor of Louisiana. At one point, I walked in and handed in my resignation, not offering, but fully and firmly intending to resign on the theory that I had advised what I thought about matters, and that things were going sufficiently at variance with what I would advise and that it would be appropriate for me to just go on my way.

In my opinion, your judgment is as good and perhaps better than that of anybody they have got down there. I hope that you are around here as long as Mr. Reagan occupies the White House. I think you are doing a good job. You are not perfect, but I don't know anybody who is. I just hope you will continue to stay at what you are doing.

Now let me approach a problem that to me is rather evident. It may not be to others, but I think it is a very evident problem. I think that Paul Volcker is not playing politics in doing what he is doing. He may be in error, but he is not playing politics with it, in my judgment. And his story goes something like this: We can't stand the deficits in the areas that have been projected, we should reduce them, and they must be reduced if we are going to control inflation and if we are going to get interest rates down. And he suggested in good faith—I know he is in good conscience in suggesting this—that we should reduce spending by whatever amount we can reduce it and having done that, we then ought to look to the revenue side.

I was at the White House when my colleague Bennett Johnston suggested to the President that the third stage of the individual tax cuts should be made dependent upon the performance of the economy. I, myself, intervened at that point to say that I thought the President would be more concerned than anybody else about it, and that if we couldn't afford that third stage that he himself would be asking us to call it off.

Frankly, as it stands today, I don't think we can afford it. I think we ought to defer it just on the basis that when we can afford it, OK, you get the additional 10-percent cut. But that if we can't afford it—if you are giving back by way of inflation everything you are gaining by way of a tax cut, and many people are getting a lot more back by way of inflation than they are getting by the way of a tax cut—then we ought just to defer it. I think that ought to be done. And if we don't do that, they are going to have to find something else to do on the revenue side. We are not doing anybody any favor when we project the idea of a tax cut, but what we are giving in a tax cut doesn't even make back what is paid by way of inflation. I would hope that you could help us to pursue that kind of policy as I have been urging others around here. Just keep saying it. The boss might not agree with you, but if he hears it enough, after awhile, he probably will come around. I have been urging

Senator Dole and others, and I urge you too, to keep saying it because that is the direction you are going to have to go. You are going to have to do something on the revenue side. You can't do it all on the spending cuts. I'm willing to vote for a lot of these spending cuts. I voted for most of them last year.But you can't do it all that way. You are going to have to do something on the revenue side as well.

I would hope very much that you would advocate that down there. I think you have been doing it. And I would urge that you and those who have a similar responsibility would continue to do so. My impression is that if you write about something and the other fellow doesn't agree, you've got to say it more times than one. The first time he won't agree with it, but the second, third, fourth, or maybe the tenth time it begins to get through to him. I think you are going to have to do something on the revenue side here.

Mr. STOCKMAN. Senator, I appreciate very much both your compliments and your advice, but I think I shall not say anything about either in the present circumstances. [Laughter.]

Senator LONG. Well, I hope you will say something down there. [Laughter.]

The CHAIRMAN. Senator Danforth.

Senator DANFORTH. I agree with Senator Long on both scores. Let me see if I understand your position and the position of the administration. One, you do feel that it's important to get the deficits down. That that is the best way for us to bring down interest rates. And that time is of the essence. That we have to move fairly quickly. Am I right so far?

Mr. STOCKMAN. That's correct.

Senator DANFORTH. Second, you have proposed, for example, with respect to medicare what you describe as detailed and microchanges. With respect to revenues, you have proposed, I think, eight revenue enhancements. So in order to bring the deficit down, the administration has a series of detailed ideas for doing it. Now the question I have is how do we marry these two approaches. On one hand, the need to bring the deficit down and to show fast action. And on the other hand, a whole series of little microtype approaches to doing it. Is it possible, would it be possible for us to think in large terms at least for the next year or so, and somehow leave open the detailed or micro questions, cite them out in the future? My concern is that there are so many of them and are so controversial that they are going to embroil us in a lot of controversy and a lot of fights. Under the best of circumstances, it would take a long time to work them out. And, therefore, maybe some sort of freeze or some sort of broad approach which would include spending, which would include revenues at least for a short term, and set us on the right track, and then give us the time to work out the microtype details would be perhaps the wisest approach.

Mr. STOCKMAN. Senator, I think there's a lot of merit to what you are saying in the sense that under present circumstances it would be very difficult to achieve an 800- or 900-page bill with all of these detailed targeted microtype changes. However, I would suggest that you do run into a conflict of legislative efficiency versus social equity, and in some cases you simply cannot achieve savings without doing harm to some beneficiaries while creating tolerable results for others.

I would also point out that in medicare and medicaid there is no across-the-board change that I can think of that would save any money or that would be practical or fair. Nevertheless, between 1982 and 1984, just 2 years, you will have a $20 billion growth in medicare and medicaid under current law. If you asked the detailed programatic changes that we have proposed or any other changes, you will essentially leave this area unaddressed. That is such an important part of the budget growth, that would be difficult to do. There is obviously room to do it but I don't think you can do it entirely with a few big formulas, you may need some details.

Senator DANFORTH. What I asked is is it possible, at least for 1 or maybe 2 years, to establish some sort of cap, some sort of short-term containment. We will not spend more than *X* dollars or more than *X* amount of a percent of 1 day's hospitalization. Some sort of big short ranged cap which would have real budgetary effects, but would leave for future—and I don't mean the distant future, I mean beginning now—the concern for all of the micro matters.

Mr. STOCKMAN. I think in many of the cash base programs that would be possible through some kind of temporary formula, although again I refer back to my testimony where I pointed out that it can't be done on any permanent basis or you get severe inequities because of the differential needs of beneficiaries.

On medicare and medicaid, I think it would be very difficult. We proposed such an approach last year—a 5 percent cap on medicaid cost growth in reimbursement to the States with a variety of flexible powers to the States to attempt to achieve those savings. That was rejected in the legislative process and strongly opposed by many of the States. Perhaps the climate is different this year, but last year's experience doesn't make it appear terribly promising.

On medicare, I can't think of any kind of generic or simple rule based cap that could be productively or practically applied. Perhaps the committee can come up with something as a temporary expedient; it would be very difficult.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. Thank you, Mr. Chairman.

Good morning, sir. As I am sure you have learned, the distinguished ranking Republican member of this committee, Senator Packwood, said just a week and a day ago that the Republican party had just about written off those women who work for wages in the market place. And one of the matters that has concerned us about the new budget in both sides of this committee, is that beyond having written off such women, if they are women who are on welfare and who also work, you seemed to have declared war on them.

We have a report which was prepared at the University of Chicago by Tom Jowell, who was formerly an assistant to a Republican Secretary of Health, Education, and Welfare. That says that under the administration proposals, in 24 States, a mother working almost full time will be better off by quitting her job and depending entirely on welfare. There will be a net gain to the family.

For the Nation as a whole, it argues the marginal rate of taxation will be 99 percent. You get a penney for every extra dollar.

Now, sir, in many articles and papers, many important ones, you have argued that the high marginal tax rate is the analytical key to welfare problems. In 1978, the Journal of Socio-Economic Studies, you wrote,

> High marginal tax rates introduce perverse incentives that erode family stability, decrease parental responsibility, and encourage welfare fraud among the beneficiary population. In short, high marginal tax rates are the analytical key to understanding the whole range of problems associated with the welfare system.

Now, David Stockman, yesterday we had a turbulent meeting with the Secretary of Health and Human Services who seemed to think we were talking about what was enacted last year, and didn't seem to know very much what was being proposed for this year. Last year, we ended the 30⅓ provision after 4 months, as you know. This year, it is a much more complex step, which Joe has analyzed.

Will you help us? Will you walk us through this? Have you changed your mind? In your testimony you say, with a sort of fantasy weariness that welfare reform is inherently impossible. All right. If it is so impossible, why do you want to make it worse? You can't make it better, why do you want to make it worse? Or in what sense do you think a 99-percent marginal tax rate is not worse, given the fact that in theological hierarchy of symbols in this administration, marginal tax rates comes next to God. [Laughter.]

Mr. **Stockman**. Senator, it's with some trepidation that I even approach a discussion of this topic with you, although it was your book that convinced me that welfare reform was inherently impossible. [Laughter.]

But my statement in the testimony today was that lowering the marginal tax rate as a way of solving the work incentive problem, in my judgment, is inherently impossible. In the article you cited, that's precisely the case I made. After I discussed the incentive effect of high marginal tax rates in that article of 2 years ago, which was not the administration's views but my views at the time, I proposed to abolish AFDC and replace it with something entirely different.

Now what we have proposed here——

Senator **Long**. Wouldn't that be reform which you find inherently impossible?

Mr. **Stockman**. Well, I said reform of the current structure of means tested family benefits is very difficult, for all the reasons that you know. What we have proposed is that we use eligibility screens and work fair requirements as a way of dealing with the work incentive problem, rather than a futile effort to try to design a program that has a low enough marginal tax rate to encourage people to work without it, and that expands and broadens coverage so tremendously that we can't afford it or it wouldn't be desirable social policy.

Senator **Long**. Do you agree that you are raising marginal taxes?

Mr. **Stockman**. Yes.

Senator **Long**. That's an honest answer and a clear one.

You seem to understand some of the terminology. Yesterday we had a lot of problems with that. But you are raising marginal tax rates?

Mr. **Stockman**. Yes.

Senator **Long**. And you think it's a good idea. And that's a perfectly legitimate proposition. But what is difficult is when people say "huh?" [Laughter.]

Mr. **Stockman**. Senator, I don't know what transpired yesterday but——

Senator **Long**. Just as well. You have to live with these people. [Laughter.]

Mr. **Stockman**. I don't think those comments are entirely fair because Secretary Schweiker and I spent some considerable time discussing this. We both, over a period of years starting in your camp or at least the camp you were in in the early 1970's, have moved to a different position, and that is the work incentive problem that needs to be dealt with. It can't be solved because of the iron triangle effect that you are aware of by lowering the marginal tax rates. Therefore, we need to set that aside as a concern and deal with the problem by providing an ample program for the nonwork capable and a work requirement and eligibility screen for the work capable. I think if you analyze that approach all the way through, then the studies that are coming out of the center in Chicago are interesting. But I am not sure they are any kind of debilitating critique of the kind of approach that we have proposed.

Senator **Long**. Well, sir, if I don't agree with you, I even so thank you for a very forthright and clear response.

The **Chairman**. Senator Bradley.

Senator **Bradley**. Thank you, Mr. Chairman.

Mr. Stockman, in your summary statement, there is the following sentence: "The combined impact of much higher interest rates than we expected, a recession that we did not expect, and an inflation rate that is falling faster than anyone anticipated has been to increase the deficit in 1982 from $31 to $57 billion.

Now there are some of us that think that your program produced the higher interest rates and the recession. My question to you is, How could your policies reduce results that you did not expect?

Mr. **Stockman**. I don't think I suggested, Senator, in my testimony that our policies produced those results. I'm suggesting those events, those developments, occurred for a variety of factors. In some substantial degree, the economy was very weak and when the money supply was tightened last year, perhaps slightly more than was intended, that underlying weakness in financial markets in the economy tripped in the recession that we now are dealing with.

That isn't to say that our policies caused that series of events, but we had a circumstance in which there was a high risk and the recession has occurred.

Senator **Long**. I'm sure that you are getting calls from people in the investment community just as I am who feel that it was the tax cut last year, 3 years in nature, a drain of $750 billion in resources over the next 5 years, that ignited those expectations that interest rates would remain high. And, therefore, precipitated the much higher unemployment, which, indeed, is a recession; 2 million more people out of work than you predicted. Now the question is, How can we look at your projections this year and think that there is any credibility if they were so wrong last year?

Mr. STOCKMAN. I think, as I have said on many other occasions, these projections do not come out of a black box. They are not based on a theology, they are based on methodologies that are known to CBO and everyone else. They are based on explicit economic assumptions. If you think they are wrong or optimistic or not compatible or consistent, you can easily change those economic assumptions and have CBO reestimate the budget, which they constantly do.

In our budget document this year, anticipating your concern and that of others, I've provided three budgets. The budget outlook with our main forecast, plus the budget outlook with a higher growth rate and a lower growth to indicate the boundaries of where the budget would be depending on how the economy unfolds. I don't think there is any scientific answer, it's just a judgment question that everybody has to make as they look at the overall fiscal policy.

Senator LONG. Well, it's clear that we are going to just disagree on what caused the recession and what caused the higher interest rates. And sooner or later the people will decide what caused those. But we do have this problem now. And I wonder if you've considered on the revenue side, the possibility of an oil import fee. A $5 oil import fee would raise roughly $18 billion. You have the price of gasoline dropping. You have an auto industry that is tooled up for small cars. There will be real problems if the price pushes them back to bigger cars. You have a situation in Mexico where our whole financial structure is endangered by a country that's approaching default related to the drop in oil prices worldwide. I'm curious what your attitude toward an oil import fee as a possible revenue raiser might be.

Mr. STOCKMAN. Well, Senator, I think you've listed a pretty persuasive array of reasons why that might be something to consider. We did not propose it in our budget, we are not contemplating that it be proposed. But I am certain that if you and other members of this committee of the Congress would make such a proposal, we would look at it carefully. Under current circumstances in which both the nominal and real price of oil is falling, such a fee might make more sense than it has in the past when consumers were faced with rapidly rising prices, and an additional burden simply wasn't possible.

Senator LONG. What is your assessment as to whether indeed we could break OPEC with this import fee?

Mr. STOCKMAN. I don't think you could break OPEC with this import fee. As an academic matter, you might protect some domestic investment that has been made in conversion and high cost production premised on a higher price. I think that is what you are getting at.

Senator LONG. One last question. In the President's economic report, there's a sentence here that has troubled me, and I would like for you to explain what it means. It's on page 105, and I will read it to you. "There are important differences, however, between implicit and explicit debt. These implicit promises to pay social security benefits are not legal commitments. As a consequence, they have a different legal standing from explicit form of government debt." Now that sentence has troubled a lot of my constituents. And I wish you would clarify the administration's position on fulfilling these implicit promises to pay social security benefits.

Mr. **STOCKMAN**. Well, Senator, I'm not familiar with that passage. I note it was written by economists; therefore, there is probably some difficulty in penetrating what the meaning precisely was.

Senator **LONG**. But does this administration believe that promises to pay social security benefits are not legal commitments as this document issued by the President's office says?

Mr. **STOCKMAN**. Well, Senator, I think there is no doubt that we believe the social security guarantees that Americans have earned must be protected and must be paid. That's why the President proposed this Commission to come up with solutions to the serious near- and long-term problems we face. I think that passage, if I hear it correctly, is pointing out a legalistic difference between the public debt, which legally we are obligated to pay—someone can file a claim against the Government if debt obligations are not redeemed—versus social security unfunded liabilities in the future, which we are morally committed to pay, but for which you in the Congress and we in the administration must jointly raise a tax if we don't have the money in the fund to meet current obligations. We have a moral obligation, but we don't have a legal obligation in the technical sense. If we run into solvency problems, we must undertake action to insure that that doesn't occur. I think that's what the distinction is in the passage that you have cited.

Senator **LONG**. Thank you very much.

The **CHAIRMAN**. Senator Boren.

Senator **BOREN**. Mr. Chairman, I apologize. I was not here to hear the earlier questioning. I wanted to ask a question in regard to the social security student benefit.

Mr. Stockman, as you know, these benefits will not be paid to anyone not enrolled in post-secondary education by May of this year. The intent of this provision was, of course, to grandfather in last year's high school students who might have been in college this spring. The unintended effect of the May deadline has been to encourage this year's high school seniors to drop out of school prematurely and enroll in college to meet the May deadline. In order to alleviate this problem, Senator Levin has introduced S. 2107, which delays the deadline until October. I wondered what the opinion of the administration is in regard to this bill, or does the administration have some alternative to it that might make more clear what we are trying to do here?

Mr. **STOCKMAN**. Well, we haven't reviewed and come to any explicit position on that. My own view would be that it was an unfortunate choice of date, but that it was a good policy change because people who need support for higher education are eligible under means tested programs. I therefore feel that we shouldn't tamper with it at all. Whenever you change a program in midstream, there are going to be some people caught right before and right after the change with anomalous results. This was an important and justified change that had bipartisan support, and I think we ought to leave the law precisely where it is today.

Senator **Boren**. Might we at least look at, in terms of the May deadline—if you extended that forward a month or two or as Senator Levin suggested, that is not going to hurt anyone who has been relying upon the deadline. Why don't you at least look at that to see if there is a technical change that might be in order?

Mr. **Stockman**. Senator, we could look at that, but I would urge that we not move it to October because then you would make eligible another whole cohort of entering higher education students, freshmen. That's a reversal of the policy that the Congress chose.

Senator **Boren**. Well, you might consider June or you might consider some other date that would be more of an accurate reflection that wouldn't affect this school year. I'm not differing with you on policy, but on that matter.

I wonder. I was concerned this morning when I picked up the front page of the Washington Post and read the report yesterday that the President had met with the Republican Senate leadership. And in the course of it, he blamed the Democratic Party for the economic situation that we now confront. I must say that I took that rather personally. I haven't been in the Senate 20 years as was stated in the paper. I haven't been in public office 20 years. I've been here 3 years. Since I have been here, I have had consistently one of the highest ratings in terms of various organizations that rate people on the basis of trying to hold the line on spending. Last year, I did support the President's economic recovery program. I had, again, one of the highest ratings of support.

Now I am very concerned with this kind of blanket rhetoric. One, I would like to ask you whether or not you think it applies to me, because I happen to be a Democrat. Two, I have suggested that I think we ought to get deficits down, which is one of the reasons I supported the President last year. I thought he was serious about it. He was saying at that time it was important. I wonder what he would be saying if he were still a private citizen about the size of the deficits that we are now projecting.

And, three, is there going to be a change of attitude and a change of spirit if he desires to put together a bipartisan budget that will have some opportunity to pass. Because, frankly, I don't think the budget you have submitted has 10 votes in the U.S. Senate. And I think there would be fewer in the U.S. House of Representatives.

I say this out of real concern, because I think we have serious economic problems in the country. And how in the world are we going to resolve this deadlock if we engage in partisan rhetoric? I don't know. So I guess I am asking you, does the administration appreciate or not appreciate sincere bipartisan efforts by Members of this Congress to try to put together a budget that will be accepted by this Congress—that people like I and others who have been cooperative in the past can participate in. Or should I take the statement of yesterday literally, and say that I was being personally castigated because I happen to have a Democratic Party label even though there are many people on our side of the aisle as sincerely concerned about deficits as there are on the other?

Mr. **Stockman**. Senator, I'm not sure which quotation or phrase that you are talking about. I don't believe there was any intent to be partisan or suggest anything adverse about you or the Democratic Party. I think the President basically believes there are two groups, two camps. Those that want to help solve the problem, and those that want to impede the solution. I know I believe, and I know he believes, that you are in the first camp, as is every other member of this committee, as near as I can tell from the discussion today. I think we will make a determined effort not to use political labels, and I hope that in the weeks and months ahead a common recognition of a common problem can lead to a joint solution that many on this committee and in the Senate and House can embrace.

Senator **Boren**. Well, Mr. Chairman, I don't want to go beyond my time. But let me just say that I hope that that message will be carried back down to the White House. It appears to me that there are one of two things that will happen. The budget submitted by this administration is not going to be accepted. That surely must have been made clear in the meetings yesterday. I didn't happen to be in that meeting, but I am sure it must have been made clear. Anybody that has counted heads in the Senate knows it is not going to be accepted. It means we are starting over. It means that there are a lot of people out here in a very sincere bipartisan process who want to start over. And want to start over on a basis of the first goal to get the deficits down so we can get the interest rates down. And I would just say that it seems to me the President has two options. Either he can stonewall and say and make partisan comments and say, in essence, let the Congress take the blame. No matter what happens in the country, I am going to opt out of the budget process. Or he can open the door to some sincere negotiations and say I want to be a part of the bipartisan solution. Because it seems to me that if he continues the same path, he is going to become irrelevant and not a part of the budget process, which will have to be written in by Congress. And I can just say only as one Member that I hope he will be a part of the budget process, and a part of a bipartisan process. But it seems to me time is running on the option.

The **Chairman**. Well, just let me comment. I was at the meeting and—as I said earlier to Senator Bentsen—I apparently missed the part about partisanship. I haven't heard a bit of partisanship on the Democratic side so maybe I wasn't listening to hear any from the Republican side on the budget. We've had a lot of shrill partisanship—not much action but a lot of rhetoric. But I must say that the President, I think, has been in politics as long as most of us, and has a fairly good understanding of it. I left the meeting with the feeling that the President will compromise but compromise with whom? I mean how many votes does Hollings have; how many does Domenici have; how many does anyone else have? We've all got a list of numbers but how many votes do we have?

I think there will be a bipartisan approach. And some who are saying they want it probably won't be around at the time it is born or the time it is voted on, but others will be. I'm very optimistic after having lunch yesterday, and asking a question of the President. I certainly appreciate the Senator from Oklahoma's past support and what I consider to be an indication of future support. But this can't be done on a partisan basis. I've been around long enough to know that some are going to say they want a solution but who really don't.

Senator Byrd.

Senator **Byrd**. Mr. Stockman, if I remember correctly, in your reply to one of Senator Bentsen's questions, you indicated, although I am not sure you specified, that the deficit for fiscal year 1982, the current fiscal year, will exceed $100 billion. Is that correct?

Mr. **Stockman**. That's correct, Senator.

Senator **Byrd**. So the deficit for this year will exceed $100 billion?

Mr. **Stockman**. That's correct.

Senator **Byrd**. Now under your own figures in which you assume Congress will do everything that the administration seeks, the deficit for next year, 1983, will be $91.5 billion?

Mr. **Stockman**. That's correct.

Senator **Byrd**. Now in your judgment, is it your frank view to this committee that the budget deficit for fiscal year 1983 will not exceed $100 billion?

Mr. **Stockman**. Senator, I think that depends entirely on what action is taken by the Congress jointly with the administration in the next 3 or 4 months. If no action is taken, or if partial action is taken, or a stalemate is reached, it will be well over $100 billion—substantially over $100 billion. If a package can be put together of the type that your chairman was just talking about, I have no doubt that we have it in our capacity to put together a budget with a deficit that could come in well under $100 billion.

Senator **Byrd**. Assuming your own figures—we use your own figures for 4 years, fiscal year 1982 through fiscal year 1985, the budget deficits by your own figures and on your own assumptions will average $85 billion. Now that's pretty close to the $100 billion figures that I asked you about when I said can this country survive 3 to 4 years of $100 billion deficits. And your reply was along the line that we could survive on some sort of a basis but it would be immensely serious. So even under your own assumptions, taking your own figures and your own assumptions, the budget deficits for 4 years will average $85 billion. That suggests to me that the administration is underestimating the potential damage of these budget deficits.

Let me ask you this about the interest cost on the national debt. In the current year, the figure that I have been using is $115 billion. Is that in accord with your thinking?

Mr. **Stockman**. Senator, that is correct on the gross interest on the debt.

Senator **Byrd**. Well, that's what I'm talking about.

Mr. **Stockman**. But some of that interest is paid to other Federal agencies.

Senator **Byrd**. I know. But we are talking about what does the debt cost the American people. Many of my colleagues and apparently many in the administration say or take the view that that isn't too important; you don't have to worry too much about the debt.

Mr. **Stockman**. Yes.

Senator **Byrd**. Well, let's see what the debt itself costs the American people. And as I understand it, from your figures, it will cost the American taxpayer $115 billion to pay the interest on the bonds which are outstanding. Is that correct?

Mr. STOCKMAN. That's correct.

Senator BYRD. Now on what interest assumption is that made? What rate of interest?

Mr. STOCKMAN. That is based on an interest rate of 11.7 percent for calendar 1982, and 10.5 percent for calendar 1983.

Senator BYRD. You are assuming the interest rates will come down almost 2 percent?

Mr. STOCKMAN. Well, the T-bill rate right now is around 12 percent, so it is slightly below that. That's a 2-year period and that seems a feasible decline to expect if we can make the changes in policy that we need.

Senator BYRD. Now let's put this interest cost in perspective or what seems to be perspective. For fiscal year 1983, you say the budget—the budget office says—interest cost you pay to the bond tollers will be $133 billion. That will be the outlay. Now in the same period of time, fiscal year 1983, the spending of the outlays for national defense will be $216 billion. So what the American taxpayers will be paying in interest will be 60 percent as much as the entire cost of our entire national defense structure. It seems to me that is highly dangerous. Not only highly dangerous but a heavy percentage—a substantial percentage I guess I should say—of that $133 billion that will be paid to bond tollers who are foreigners. And that money, of course, will be leaving the Nation, for the most part.

Well, I think that the deficit is more serious than the administration appears to realize. And I think this debt, which will be increased under your own figures by 40 percent in 4 years, is highly dangerous and more dangerous apparently than the administration considers.

The CHAIRMAN. Mr. Stockman, Senator Roth has agreed to preside. My wife is being roasted at Saints and Sinners. You get it on a daily basis. She's not used to it so I want to go down there. [Laughter.]

The CHAIRMAN. But I do want to put in the record a statement on indexing where I take slight issue with Donald Regan, the Treasury Secretary.

I appreciate again very much your being here this morning. Thank you.

Mr. STOCKMAN. Senator, I would only say that sometimes down at the White House it is not your wife that's roasted.

The CHAIRMAN. No. This is another event—Saints and Sinners. It wouldn't bother you at all because you get it every day up here, but it is new to her.

Senator ROTH. Mr. Stockman, I'd like to underscore what the chairman said earlier when he mentioned the fact that the President has indicated—and I think indicated very strongly—that he is willing to listen to all groups. And that he's eager to work with a bipartisan group. I think basic to his position, and certainly basic to my position, that in reaching such a consensus in no way can we undercut the basic Economic Recovery Act. And by that I mean the individual 3-year 25-percent tax cut, plus the indexation.

We have tried for years, we have tried for years to balance the budget on the backs of the taxpayer. And to be realistic about it, the working people have not yet received any tax cut. The social security increases adopted a few years ago have offset any impact of the 5-percent tax cut of last year. It will basically offset any tax cut this year so that the first tax cut that the working people are getting will be the 10 percent next year.

I think it is important for you to understand, as well as the administration and my colleagues, that there are those of us who will fight long and hard and have an extended debate on any effort to reverse these steps that were taken to get the economy moving again.

Now last fall, all the talk was about inflation. And that was a serious matter. Inflation has gone down. I don't hear too many people noting that, although it is an important plus. At the very same time, all the talk is about deficits, but no talk about how you get the economy moving again. Fundamental to that is to avoid this ever-increasing Government, ever-increasing taxes. So I wouldn't want anyone to walk away from here with the idea that there is going to be some compromise, some consensus on the part of many of us to undo the first real tax cuts that have been given to the working people.

I would also point out that small business—really the only tax cuts that they are getting, because there are not many of them that are incorporated, is through the individual tax cuts, so it would have a very, very serious impact on them.

Having said all that, I agree that there is room for compromise and consensus. I listened with a great deal of interest to some of the suggestions made on the other side. I've wondered if we have to finally adopt some kind of revenue enhancement, some kind of oil severance tax. You could get several billion dollars that way. It wouldn't only have to be limited to oil, but possibly coal. So there are ways and means that would not undercut the economic recovery, but if necessary, and only if necessary, increase revenue. But I think what the American people want us to do is to take a careful look on the spending side and take every measure. And make no mistake, there are going to be those, if you increase revenue, that are going to increase Government spending.

Now one comment that was made by—a reference made by Senator Byrd, rightfully so, was about the high cost of interest to the Federal Government. And there have been a number of proposals recently that we might do something about the interest rates that the Treasury is paying if we issued some kind of a 10-year note. If they issued some kind of a 10-year note that paid the rate of inflation as measured by the GNP deflater, plus a small fixed real rate. In other words, the cost of inflation is now what, annualized?

Mr. STOCKMAN. Well, at the present time it is running inside the 6-percent range. But that is only a short period. It is probably higher than that—7 to 8 in some underlying sense.

Senator ROTH. But if you put a 1- or 2-percent real interest on top of that, the Federal Government would be paying a lot less, a lot less, for its securities, or interest on its securities as it now is. Do you have any comment on that approach?

Mr. **Stockman**. Well, I have heard that suggested a number of times. We are analyzing it. I don't think the savings would be nearly as great as some have suggested. Right now, you would probably use last year's inflation rate to index the payments each quarter this year since you would have to have more than just a month or two on which to base the payment. Last year's inflation rate was somewhere in the range of 9½ to 10 percent or 9 to 10 percent. And so, therefore, if you took that, plus a 3-percent coupon rate, you would be paying almost precisely what you are paying on a T-bill today. Now as you get down the road, that might improve. The inflation rate for 1982 will be much lower; therefore, in 1983, we might get away with a lower cost. But there is some danger that the market would demand a discount on these securities that you would issue, and as a result, on a net basis, I'm not sure how much you would really save. Nevertheless, we are looking at this proposal as well as others.

Senator **Roth**. It might be a trial run. I notice it working apparently fairly well on the corporate side.

Mr. **Stockman**. Well, you have got the lag problem, Senator. I would point out that you can't pay quarterly interest to a security holder based on the inflation rate during that quarter because you don't know what it is and a quarter is too short a period of time so you must use last year's inflation rate. If inflation is coming down, then last year's rate is always going to be a point or two higher than the current rate, which would bring it closer, probably, to the market interest rate you would be facing.

It's useful to look at, but I want to tell you that I have seen numbers like $10, $15, and $20 billion in budget savings as a result of novel securities, unconventional bonds, and so forth, and there isn't any possible savings remotely of that magnitude. Nevertheless, it still needs to be looked at.

Senator **Roth**. At the same time, it makes no sense to me, not only as far as the Federal Government is concerned, but in the private sector, to have interest rates as high as they are when inflation is down. And traditionally, if you earned a real return of 2 to 3½ percent, that was considered a good return. So I would urge that this be carefully reviewed.

Senator **Byrd**. Could I ask a question?

Senator **Roth**. Yes. I yield to Senator Byrd, if nobody objects.

Mr. **Stockman**. I don't object.

Senator **Byrd**. I just want to ask a question. Do you feel the key to it is going to be whether the people will buy the bonds? Do you think anyone would buy a 10-year bond based on this year's inflation?

Mr. **Stockman**. I think the idea is that the annual or the quarterly interest payments would be a fixed rate like 2 or 3 percent, plus the inflation rate for the previous period. So, therefore, someone would be theoretically fully protected against inflation, plus have a real rate of return on the bond.

Senator **Byrd**. Well, my followup question is: Does not a government bond need to be competitive with other instruments of value, of money?

Mr. **Stockman**. Well, that's why I was suggesting to Senator Roth that there would be a discount from the face value that we would have to take on the bond. We would raise less money that way. We would have to pay off more at the end, and I'm not sure that there is any cash flow savings, although we haven't figured it all the way through.

Senator BYRD. So you've always got to pay the going rate?

Mr. STOCKMAN. That's right.

Senator BYRD. One way or another. Either with a discount in bond or with the interest rate.

Mr. STOCKMAN. I think so. That's why I said there would be a discount.

Senator BYRD. If you are studying this question, you might want to take a look at what the Government did—I can't remember the last year, but it was during the Ford or Nixon administration in which the Government had prepared to come out with a 7-year bond—I believe it was—at an 8-percent interest. Inflation was way down at that point compared to what it is now. As I recall, they couldn't sell the issue. They had to withdraw it. They sold about half of it, and withdrew the rest.

Senator ROTH. All I would say to the Senator from Virginia is that I think that the rate that is being paid is too high, and that it is worthwhile examining some other proposals. There are some economists, very responsible economists, who think this offers a reasonable approach.

Senator Mitchell.

Senator MITCHELL. Thank you, Mr. Chairman. I would just like to make a comment. Here's the glass that someone described as half full and some half empty. Senator Roth describes the President's action in recent days as forthcoming and wanting to compromise. I want to say to you, Senator, that with all due respect I see them in a completely different fashion. As a Democrat, I feel that the President's actions have been highly offensive. They have been filled with shrill partisan rhetoric attacking Democrats, blaming Democrats for the current problems. We all want to do what is right. But here on the one level we have the President going around the country blaming everything in the country on the Democrats, and saying they are the cause for things. On the other hand, we have people like Senator Dole, Senator Domenici, saying that we now have to have a bipartisan compromise. The point I want to make—I have made this earlier, Mr. Stockman, I make it again—is that there is not going to be a compromise unless there is an attitude that suggests that we are all in this together. There may be two political parties, but there is only one economy and it's an American economy. The American people are suffering. There must be a joint bipartisan effort, and it cannot succeed, it cannot succeed, unless the President tones down his rhetoric, and indicates some willingness to participate in a meaningful way in this effort. We look at the same facts, and we reach different conclusions. Just tell me what it looks like from this side.

I would like to pursue one other subject, if I could. Senator Byrd talked with you at length about the projected deficits. Now I have before me a table showing four sets of figures. Yours and the CBO's under either the present law unchanged or assuming the President's program is adopted in full. Now the only one of the four that projects a decline in the deficit is yours, assuming adoption of the

President's program into law. Of course, that is by far the lowest of the estimates. They range, for example, for $83 billion to your low, acceptance of the President's program at $91.5 billion, up to the CBO's, $157 billion.

Now it is obvious that the financial community of the Nation has rejected the budget figures proposed by the President's program, assuming it is accepted, as unacceptably high.

Mr. Stockman. Senator, I don't think I would agree with that. I think the financial market has responded to the fact that those proposals might not be implemented or adopted, and that we would end up with a deficit of $147 billion under ours, or $157 billion under CBO's current law estimates. That's what the problem is, and that is a matter that we all can resolve over the next several months as we work through the process.

Senator Mitchell. All right. Then what I really would like is your sincere judgment as to what level of deficits would be acceptable, and would induce the kind of psychological change that is so necessary in this country to get a turnaround to bring about the recovery that we all want. Do you think that if the levels in your program were achieved that would do it? That is, if they really thought it would be a $95 billion deficit?

Mr. Stockman. Yes, I think so, if they were achieved credibly and reliably, and if the measures to insure they didn't exceed that level were locked into law through completed appropriations action, completed entitlement changes, completed revenue raising measures and so forth.

As I said before, the real uncertainty here is one of political and legislative process, not one of numbers so much or of the particular policy measures required to get there.

Senator Mitchell. But, see, some of those who are proposing alternative budgets are doing so on the assumption that it's contrary to the assertion you have just made. I am sure you are aware of that. It is their assertion that the deficit levels must be brought down some figure below those projected in your figures and below the $95 billion credibly achieved. I gather what you are saying is you really don't feel that would be necessary. That if we could just actually produce deficits at the levels projected, $95 billion in 1983, $83 billion in 1984, and $72 billion in 1985, or something along that range that that would be enough in terms of the necessary psychology needed to turn this thing around.

Mr. Stockman. Well, I would make two points. One, I think the markets have now discounted the budget up to $130 billion because they don't see any signs at the moment that major budget saving action will be taken. Second, that if we could achieve the deficit path that we have laid out—$92 billion in 1983, $83 billion in 1984, and $72 billion in 1985—there would be a tonic effect on the market. If we could get deficits lower than that, the effect would be greater; the effect would build even more.

If we could achieve the path that we have laid out by implementing into law this year all the measures that we need, I think you would see a considerable shift in financial market expectations and interest rates.

Senator Mitchell. Could I ask one more question, Mr. Chairman?

Senator ROTH. Certainly.

Senator MITCHELL. You are next, Senator Long.

Senator LONG. I yield.

Senator MITCHELL. Thank you.

Would you give us some indication—if that were to occur, what kind of a timetable for the projected turn around? Do you look at a fairly rapid recovery? A rather swift turn in unemployment? Real increase in economic growth over the next few months?

Mr. STOCKMAN. Well, I think you are really getting into a speculative realm there. I would say that in our economic forecast, we expect, if these deficit targets are achieved—and this is the question you are really asking—that the first quarter will be negative. That, of course, is what it has been. We expect that we will reach bottom in the second quarter and the economy will then begin to emerge from the recession. We would then get strong growth in the third and fourth quarter of this year. We haven't published our quarterly numbers, but that's basically the path we see. If we achieve those deficit targets, that's the outlook that I think would be reasonable to expect. The economy would turn around in the second quarter, and then in the second half of the year you would move from a small plus to a very strong plus in terms of business activity, output growth, and employment reduction.

But still recognize—and I think you do—that we are going to begin this recovery at about 9 percent unemployment or in that vicinity. It is going to take a while to reduce that employment rate simply because of the way those numbers work together.

Senator MITCHELL. Thank you, Mr. Stockman.

Senator ROTH. Senator Long.

Senator LONG. I would like to ask and I would like to have some of your thinking on this subject with the understanding that this does not bind the administration. It may be that you can give us some thoughts. It would be helpful to all of us. Is there a welfare reform?

In the first place let me say that my impression has been that the President's point of view was well taken. He appeared when he was Governor of California before the committee on at least two occasions, and he was probably the best witness of the public witnesses that we had speaking for position. He made his statement so that people could understand. I know when the family assistance plan was sent up here, I think what really killed it in this committee was a statement by Ronald Reagan and Roger Freeman, both of whom took pretty much the same point of view. They articulated it somewhat differently, as you might expect. But, basically, it was the same fundamental point of view that the idea being that if we are going to pay people where they can live comfortably without ever doing the first decent act or doing anything useful—once you saw it from that point, you just can't make the rest of it work. You talk a marginal tax rate being 99 percent. You wind up in all sorts of ridiculous situations. So having thought about that for years upon years, it has just convinced me that you can't get there from here. If you start out providing a living wage for doing absolutely nothing, there is no way you can contrive a program, and I have thought about it a lot with everybody else's ideas. You can't work out a program that is going to make any sense at all to the people who are paying for all this thing once you saw it on that basis. So it works out to the basis that if you are going to have a program that makes any sense at all, you are going to have to pay able-bodied people to do something rather than paying them to do nothing.

Now you can go before any audience, other than the welfare clients themselves—I don't know how they would respond, but I do know how everybody else responds to it—and talk to them about the fact that the old WPA made better sense than the present welfare system because a lot of people were out of work. They wanted a chance to make an honest dollar or an honest day's pay for work, and you put them to work. People approved of that. They might not think they approved of it so much at the time, but when they look and see we are paying people for doing nothing, they look at it entirely differently. Furthermore, some of us chuckle behind the scene that those who wanted to abolish those steps, wanted to get rid of it because of the complaints of those who stand right behind those same people in line and watch what they are doing with those food stamps.

Now to me it makes all the sense in the world that the program should be moved into a situation where we pay something to do something. In the area of day care and the laws we have sponsored on this committee and put on the statutes means a practical matter between State and Federal—it is really almost all Federal—we are paying 100 percent of the cost of putting a welfare client to work in a day care. That's better than paying them for doing nothing. At least they are active; they are doing something. I don't see why we can't do the same thing for hospitals, the same thing to help keep a place clean, the same thing to help beautify the community. Why can't we move in that direction?

Now let me just take issue with you about community work. There is one big problem to it and that is that it projects the image that you have given the person the gift and now you are being an Indian giver. You are asking him to work for the money. It seems to me that you would be a lot better off if you must do it that way to take the view that here is one check as emergency assistance. Assuming you are hungry, and you have got to have something to hold hide and hair together until you can earn your first paycheck. If you are going to do that, I think it ought to be here is one check for emergency assistance and then from then on you are on your own. We will pay you to do something, but we are not going to pay you for doing nothing. Now why shouldn't we take that attitude about anybody who can do anything that is useful?

Mr. **Stockman**. Well, Senator, I would respond by saying your analysis, I believe, is precisely right. I was trying to make that point to Senator Moynihan before but apparently he doesn't accept our common point of view on this.

I think there are three important things you can do to reduce dependency. The most important thing is on the books today, that's the earned income tax credit because that provides a transfer payment reward for working. You don't get the credit unless you work, so it is self-executing in terms of being tied to work effort. The greater the work effort, the greater the incentive that is provided.

Now I appreciate your concern about the work experience, that's the other prong of what we would see as the way of getting at it. But I would point out that under the AFDCU program, which is part of AFDC, we are proposing in this budget precisely what you have advocated here. You wouldn't be eligible for AFDCU unless you accepted a job either in the private sector or in a work experience program, so we are getting at that same objective on the AFDCU part.

On AFDC you have many people who are on today, and it is a point of who are work capable. What we are essentially saying is to remain on, you would have to accept a work experience program or lose eligibility. I think that is basically what you are advocating, so if you look carefully at what we are proposing, I think it is what you have advocated.

Senator **Long**. I just have one further question. To me, the point is that you don't have to get any high degree of things for getting these poor people to work. You don't have to get a dollar's worth of return for a dollar. You don't even have to get 25 percent in return for a dollar. But when you have the people out there doing something, marginal though it may be, even though it is not worth the money in economic terms, the public feels that those people are at least doing what they can to earn their keep. You save yourself from this trap without a 99-percent marginal tax and all the rest of it.

There is one person that pointed out to me that when the first step to get out there and do something, little though it may be, after a while the person gets the impression, well, if I have got to do this anyway, I might as well just get myself a good job. So at least they are moving toward becoming a part of the mainstream and doing what everybody else does for a living rather than just sitting there thinking up mischief to get into or becoming a vegetable or a parasite on the community, and setting a horrible example for their children. So if we improve in these areas, it will save the Government some money. But that's not the big point. The big point is that we are moving these lives in the direction that is good for those people rather than moving them in a way where they become a greater and greater burden on society. At best a parasite or something worse than a parasite. I believe you agree with that.

Mr. **Stockman**. Yes.

Senator **Long**. Thank you.

Senator **Roth**. Senator Boren.

Senator **Boren**. Mr. Stockman, would you agree that the economic recovery program would be working much better now—in other words, the tax cut would be stimulating the kind of economic growth many of us hoped that it would stimulate—if interest rates were at a more reasonable level? If the interest rates were to drop 3 or 4 percentage rates, that the amount of the tax cut could then be taken and additional funds borrowed, for example, then we would have much more business expansion?

Mr. **Stockman**. Yes, I agree with that.

Senator **Boren**. If that's the case, then why wouldn't it be the preferable course? Let me ask you a second question before I ask that. You talked a while ago about the fact that the interest rates were not coming down as much as they might because the market seems to have doubt that we are going to reduce the deficit by as much as we should or as much as the administration has proposed. In other words, that they are not certain that the deficit won't be $150 billion instead of the $90-some billion that is being projected here. So I gather you would be saying that the market reception of how large the deficits are going to be this year and in future years affects the interest rate. Is that correct?

Mr. STOCKMAN. Yes; particularly, the long-term interest rate, bond rates.

Senator BOREN. All right. That becomes very important because it has impact on mortgage rates and other things that are long term and that are very much key to the economic recovery. Well, if that's the case, why wouldn't it be better—why isn't something like the Hollings proposal preferable because it not only brings the deficits down below those being projected by the administration budget, but it could at least make possible a balanced budget by 1985? Why wouldn't that, then, result in the interest rates coming down even more? I, for a long time, wanted to see us cut the tax rates. I think if the interest rates were lower, I think that the tax cut would work. I think supply side economics will work if interest rates are at reasonable levels. The problem is we face a situation where they are not. Why wouldn't it be better to not repeal the tax cut, but to defer the tax cut, and to take other actions as Senator Hollings has suggested? Then when we get the budget into a more balanced situation, and we get the interest rates down, the third year of the tax cut taking effect at that time could have the kind of economic stimulus that it would be having now if interest rates were lower? Why wouldn't that be a preferable policy to what has been suggested here?

Mr. STOCKMAN. Well, I think I would make two points. One, as important and critical as reducing the deficit and the level of interest rates are for ventilating the economy and permitting the recovery to go forward, I don't think we should throw the baby out with the bath. In some cases, where you are proposing to cut defense by nearly $100 billion over 3 years, you simply do not have a practical, viable, or responsible reduction in spending. We just can't do that, and I think once it is examined, that will be clear.

I think on the tax cut, I would make the same point. Maybe we need to raise revenues, and we have proposed in our budget nearly $50 billion in revenue raising measures over the next 3 years. But there are a lot of different ways to raise revenues. I think from the discussion this morning and from what your committee has looked at, there are a lot of alternatives that can be considered.

Senator BOREN. Well, I think you also have to consider fairness, and those of us who want to see the budget balanced—and we are going to have cut certain programs that affect certain income groups in order to do that—I think you also have to consider that there has to be an equality of sacrifice here. That's the reason that I personally feel that we might consider not a repeal, but a postponement until certain conditions are met.

Let me ask you hypothetically. Let's suppose the deficit went to $400 billion next year. You know, some have projected as high as $200 billion. I mean is there any figure at which you would say it would not be responsible on top of that type deficit to impose additional revenue cuts? Hypothetical, any figure. If we have a $1 trillion deficit? In other words, should we say that no matter what happens to the deficits, we are going to add a $1 trillion. The range of estimates here are somewhere between $300 billion more added to the deficit over the next 3 years, and $550 billion or so added to the deficit over the next 3 years. Some have projected on out after indexing takes place to postulate deficits beyond 1985 in excess of $200 billion a year with indexing. Suppose all that is true. Suppose we are going to add another $1 trillion to the deficit over the next, say, 5 years. Is that acceptable? Or do we just have to revenue that? Is there any point, logically, where we would have to look at it?

Mr. STOCKMAN. Yes; obviously, you have two choices to finance the current expenditures of Government. You can raise taxes or issue bonds. Within some very narrow range under certain economic conditions, it is better to do one versus the other. But if you are talking about a trillion dollars' worth of bonds, if you are talking about a long period of time, if you are talking about a $400 billion current deficit, you have got to raise revenues. I agree 100 percent. But the point is that there are a lot of different ways to raise revenue, and I don't think we ought to raise marginal tax rates on the individual income tax. There are other ways to do it.

Senator BOREN. I would certainly prefer not, and I accept the idea of incentive. I've supported the program in the past. I did want to see us put a fail safe trigger into the third year, and voted for such an amendment at the time.

There is one final point. If you are in the midst of a bargaining session, and if you know you are going to lose on a certain point anyway, it seems to me that there is a sound policy you would follow that if you can get something for what you are going to lose on anyway. The kind of theory I always had about President Carter during the SALT negotiations. If he wasn't going to build the B-1 anyway, which was the decision that his administration made, why didn't he say he was going to build it and try to get the Russians to give us something in return for not doing it if we weren't going to do it anyway?

Now it seems to me that the situation that we are facing in terms of this budget is the President will not get the amount of the increase in defense spending that he is asking for. I just tell public opinion in my own State, which is perhaps the most strongly promilitary in the country—and I consider myself one of the most strongly prodefense Senators. They are not going to support an increase that large. I think he is going to lose on that point. Now I'm not saying it is going to be cut back as much as we are talking about in the Hollings proposal. I doubt that the rate of increase will be cut back that much. But there is going to be some.

I have extreme doubt that the third year of the tax cut can be held unless it is held by his veto of the deferral. Now if you are going to lose on those points; if there is clearly majority of sentiment on the other side on both of those points, but if the President could bargain to say—and I agree with the Senator from Delaware to this extent. I don't want to see us balance the budget on the backs of the taxpayers. I want to see us keep the heat on spending, all spending. If he could get significant concessions, commitments to the magnitude of spending cuts that he has already called for—maybe not exactly the same way, but the magnitude or even a greater magnitude—in return for bargaining on some points that it looks like he is going to lose on anyway. Might that not be a good process for the President to get involved in at this point if he wishes to remain a part of the budget process? In other words, I can foresee this scenario. If the present posture continues, I think that the country is going to lose because I think the President is going to lose on the defense argument; I think the President is going to lose on the deferral of the tax argument. I think in return he won't get the kind of commitment to lower spending that he would get if he could get into the bargaining process. But, instead, we are going to have a much smaller spending cut. We are going to end up with a result that is much worse for the country. Or even worst of all, we might even just end up with a continuing type resolution and not even get any resolution of the budget matter at all, and at higher levels of spending than are healthy.

I am very concerned about that. I'm concerned about that as a person that thinks the level of spending has been higher than we can afford. I would just hope that at least that viewpoint would be presented. I realize you don't bargain until Senator Dole said there is someone to bargain with. You don't play your hand too soon. But I certainly hope we are not getting ourselves so locked in that the President might, 6 months from now, find himself irrelevant to the whole negotiating process. I saw that happen to the last President. I think none of us want to see it happen to this President on either side of the aisle.

Senator **Roth**. Mr. Stockman, I would just like to conclude by saying that there are those of us who don't necessarily share the same approach. I've already stated that if there is to be a tax increase, there are many other areas including restoring the wind fall profit tax cut that was adopted last year. There will be no concensus if we are going to undermine the Economic Recovery Act. I would just also point out that so much of the attention here has been on the deficit, which is critical and important. But I think of even more importance is the desire to put in place and keep in place policies to create real growth, and that you are not going to establish that if we undo the good that we did last year. I think, frankly, the President is going to play a very key role because he has a lot of support here. I would just underscore that my own polls at home show strong support for the economic recovery, including the tax cuts. So I think it would be a serious mistake to try to reverse what we did constructively last year.

I thank you for being here today.

The committee is in recess.

[Whereupon, at 12:21 p.m., the hearing was adjourned.]

ADMINISTRATION'S FISCAL YEAR 1983 BUDGET PROPOSALS

THURSDAY, MARCH 11, 1982

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 10:04 a.m., in room 2221, Dirksen Senate Office Building, Hon. Robert Dole (chairman) presiding.

Present: Senators Dole, Chafee, Heinz, Grassley, Long, Bentsen, Moynihan, and Bradley.

The CHAIRMAN. There are other members coming, Mr. Kirkland, and since we are under some time constraints today, if it is all right with you we can proceed, and they will get here just in time to ask questions.

Your entire statement will be made a part of the record, and you may proceed in any way you wish.

Mr. KIRKLAND. Thank you, Mr. Chairman.

STATEMENT OF LANE KIRKLAND, PRESIDENT, AFL-CIO, WASHINGTON, D.C.

Mr. KIRKLAND. We appreciate this opportunity to present our views on the administration's proposed cuts in a number of important entitlement programs.

Over the last half century, an indispensable national structure of programs has been built to meet the contingencies of life for millions of Americans. Now that structure is threatened not only by unwarranted Federal budget cuts but also by an ill-conceived effort by the administration to wipe out 50 years of social progress and to foist many of these programs on States which are already financially overburdened.

We fear that the harm the Federal budget cuts are doing to our Nation is still not understood. Massive Federal budget cuts for separate programs tend to be expressed in millions and billions of dollars, obscuring the fact that they are all inter-related because the targets are the same. It is the same unemployed, the same needy who suffer from all of these cuts.

All I am going to read here is a summary of the very grave concern in the American labor movement about the people, including our members, behind those numbers—workers who are forced onto the street in this recession only to find the doors slammed shut on them where there should be help.

We are filing with the committee a more detailed look at our reaction to cuts in the entitlement programs. Suffice it to say that these people are placed in an unprecedented double jeopardy of having their jobs destroyed by the administration's blind adherence to dubious economic theory and then having their subsistence threatened by budget cuts.

Thus, the unemployment insurance system might be the best example of how all the Federal programs are related and the targets the same. Few people think of unemployment insurance as an education program or a child nutrition program, but it is for the millions of America's children whose parents are able to provide for them only because of jobless benefits. Few think of unemployment compensation in terms of health insurance, but loss of coverage is a major burden for any family which encounters unemployment.

Similarly, millions of children in families which rely solely to aid to families with dependent children to supply the bare necessities of life don't face just AFDC cuts but also cuts in child health programs, community medical care programs, daycare and the like—all of which were designed to make it possible for children born in poverty to have a chance to end the cycle of deprivation being passed on from generation to generation.

Thus, when the Federal Government abdicates its responsibilities in the areas of trade adjustment assistance or aid for the disabled, we would ask this committee to look at those cuts not as separate, isolated programs but as another door being slammed on people who in the current recession have few places to turn.

No more sacrifice can be made by these Americans of all ages who were battered by last year's cuts and now face further erosion of their meager life support programs. Contrary to reports in the news media that those who are suffering these cuts are prepared to endure further reductions to "share the sacrifice," I wish to state most emphatically that the AFL-CIO and the more than 200 organizations in the Budget Coalition strongly reject such a view. The very reason for the existence of this coalition of more than 200 labor, civil rights, senior, children, religious, disabled, health, consumer, environmental, women's and educational organizations was to fight last year's cuts and to attempt to reverse this year's inequitable burden placed upon these unfortunate Americans.

Today in America, there are more people out of work than at any time since the Great Depression of the thirties. One million jobs have been wiped out since last July, and the official figures add up the damage: 8.8 percent unemployed, or 9.5 million people, and a record total of another 1.2 million too discouraged to continue looking for work.

Last year the Congress, through reconciliation, cut fiscal year 1982 entitlement spending under this committee's jurisdiction by $9 billion. The impact of those same cuts in fiscal year 1983 was then calculated to be a reduction of $10 billion. Now President Reagan is asking this committee to cut another $1 billion in entitlement spending from fiscal year 1982 and another $9 billion in entitlement spending in fiscal year 1983.

The drastic erosion of the vital unemployment insurance system means simply that workers, particularly the long-term unemployed, are being forced to think the unthinkable—going onto welfare—at a time that entitlement program is also being slashed. It is estimated that in fiscal 1983 more than 3 million workers, jobless through no fault of their own, will have extended unemployment insurance benefits denied or cut back as a result of recent actions by Congress.

Recognizing the need for additional weeks of benefits for unemployed workers during economic recessions, the Congress has on a number of occasions enacted supplemental benefits legislation. During the recession of the midseventies, benefits were available for up to 65 weeks. We urge Congress to immediately restore the protections of the extended benefit program that have been eliminated and extend the maximum duration of benefits to 65 weeks.

RAILROAD RETIREMENT

The administration proposes to abolish the railroad retirement system. It would turn over the funding obligations—$2.2 billion—of tier I benefits to social security and change tier II benefits into a private, multiemployer pension plan. Because the financial situation of railroads varies considerably, many of them won't or can't participate in a national multiemployer plan and may try to establish separate programs with less benefits. That would result in less retirement benefits for railroad workers but would also mean a disruption in the collective bargaining process as those workers and their unions are forced to defend existing benefit levels. We strongly oppose the administration's proposals to eliminate trade adjustment assistance, redwood employee programs, and airline employee programs. These programs were all created to meet the special problems of the workers covered by them. They are necessary, appropriate and should be maintained.

SOCIAL SECURITY

In 1981 the budget reconciliation provisions made major cuts in social security amounting to $22 to $26 billion over the next 5 years.

In May 1981, President Reagan asked Congress for additional drastic cuts which, if enacted, would have been devastating to the program and to those protected by it.

When these proposed slashes were met by massive public opposition, the President appointed a National Commission on Social Security Reform. Congress should not consider changes in social security until the Commission makes its report.

We are concerned about proposals by leading members of the Senate Budget Committee to freeze all cost-of-living increases in social security and Federal retiree programs. A freeze of the social security cost-of-living adjustments for fiscal 1983 would cut the benefits for the average retired worker about $324 and for the average retired couple about $468.

Inflation has already reduced the buying power of the elderly because large parts of their income—private pensions, savings, and so forth—are not adjusted for increased living costs. Postponement or reduction of their cost-of-living protection would seriously worsen their already precarious economic situation and accelerate the increasing numbers of them being pushed into poverty.

Because social security is separately financed and because the law requires that all social security contributions be used only for social security purposes, the program should not be used to help reduce the budget deficit. To insulate social security from such inappropriate manipulation, the AFL-CIO has long advocated that it be separated from the general budget and administered by an independent agency. Only in this way can the earned rights of workers and retirees be protected.

HEALTH PROGRAMS

Slashes in Federal health programs enacted last year and those the administration now propose would leave millions of Americans without health care protection. Especially hard hit would be poor children and the very old.

MEDICARE

The administration has proposed $3 billion in new cuts on top of about $1 billion trimmed in last year's budget reconciliation bill.

The most devastating change would be a 2-percent reduction in reimbursement to hospitals. This cut would have its biggest impact on the elderly and disabled covered by medicare and the financially strapped public and community hospitals that serve them.

We also strongly oppose a number of other changes, described in detail in our full statement, which would have similar harmful effects.

We also oppose a requirement of heavy additional payments for hospitalized medicare beneficiaries which is not part of the proposed 1983 budget, but is a proposal the administration is seriously considering.

MEDICAID

Last year the reconciliation bill cut the Federal share of medicaid for fiscal 1982 by $1 billion. Just under 1 million poor Americans were cut from the rolls—600,000 of them children. For fiscal 1983 the administration wants even deeper cuts, the details of which are spelled out in the full statement, which together with the fiscal 1982 reduction would mean a slash of 17 percent from the fiscal 1981 levels of services and deprive an additional 1.1 million poor of medical care coverage, including 600,000 children.

What many working mothers fear even more than the cutoff of AFDC payments is the consequent denial of medicaid coverage for their families. The AFL-CIO, therefore, supports enactment of the House bill H.R. 5199 which would permit States to restore coverage for the working poor who otherwise would be deprived of medicaid when they lose their welfare eligibility.

AID TO FAMILIES WITH DEPENDENT CHILDREN

As a result of last year's cuts in AFDC, 750,000 families—2¼ million individuals—had their AFDC benefits reduced or completely terminated. This year the administration proposes to eliminate or reduce payments to an additional 921,000 households, or approximately 2,763,000 individuals. The net effect would be to decrease even more drastically the financial incentive for families to work their way off welfare. Spelled out in my full statement are the major specific proposals for the administration with respect to AFDC and our reasons for opposing them.

We especially object to the administration's proposals abolishing the work incentive program and replacing it with "workfare," the punitive and discredited system which forces parents to work at make-work jobs for no wages with no training and no hope of advancement.

SOCIAL SERVICES AND CHILD WELFARE

Last year's cuts drastically slashed social services under title XX of the Social Security Act. Day care centers are closing, mental health services for young children have been eliminated, services for the elderly and handicapped have stopped, and many States have already curtailed all but those services which are literally lifesaving.

The administration is now proposing an additional 12-percent cut in title XX social services. These cuts would reduce the number of people receiving services such as day care and homemaker aid from 7.7 million in 1981 to 4.4 million.

Especially indefensible is the administration's proposal to turn back to the States—at a 46-percent cut in funding—the programs authorized by the Adoption Assistance and Child Welfare Act of 1980. This would mean that one-half million children would have even less of a chance at a decent and productive life than under the scandalous State foster care system.

SUPPLEMENTAL SECURITY INCOME

The administration is proposing to end or cut payments to more than one-half of the 4 million poor, elderly, blind or disabled persons dependent on supplemental security income. Accompanying cuts in educational, medical, employment programs, vocational rehabilitation, community and social services, and food and nutrition programs will close off other avenues of survival for these unfortunate people. The cuts being sought in the food stamp program would result in eliminating or drastically reducing the benefits of 92 percent of the elderly and disabled recipient households, with the average loss amounting to $200 a year. All of these cuts must be rejected.

The AFL–CIO has proposed a comprehensive economic approach not only to provide the funds to offset the additional $41 billion in budget cuts proposed for fiscal year 1983 but also to provide an additional $23 billion in economy-reviving, job-creating programs. We also propose to correct the main inequities of the 1981 tax law to recoup $31 billion. In the full statement we also list a number of tax loopholes that could be closed to raise another $47 billion.

The President's 1983 budget proposes a $33 billion increase in defense outlays. We reject the administration's concept of raising defense spending at the cost of vital social programs; of making the poor and disadvantaged, who can least afford it, pay a disproportionate share of the costs of assuring the Nation's security.

Instead, we insist that defense needs be carefully scrutinized. If additional funds are justified they should be financed dollar for dollar from a new progressive surtax on corporations and individuals so that all bear a fair share of the common defense burden.

To create jobs, alleviate suffering and end the recession, we call for a range of investments in sewer, highway, bridge, mass transit, railroad and other essential facilities; human capital investments through effective training programs and public employment opportunities; and low-and moderate-income housing.

We call for a new Reconstruction Finance Corporation to start the rebuilding of the Nation's economic and urban industrial base.

Imports that damage already weakened domestic industries and destroy jobs must be restricted.

Our full program is attached. It's titled "An Alternative to Reaganomics" and was adopted at the recent AFL-CIO Executive Council meeting.

Mr. Chairman, as the council declared:

> This alternative economic program will put the nation on a path to achieve full employment, stable economic growth, fairness in sharing burdens and a society with compassion for those who have too little.

We commend the AFL-CIO's program to you for your consideration.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF LANE KIRKLAND, PRESIDENT
AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS
BEFORE THE SENATE FINANCE COMMITTEE
ON ADMINISTRATION BUDGET PROPOSALS

March 11, 1982

Mr. Chairman, the AFL-CIO appreciates this opportunity to present our views on the Administration's proposed budget cuts in a number of important programs within the jurisdiction of the Senate Finance Committee.

Over the last half century, an indispensable national structure of programs has been built to meet the contingencies of life for millions of Americans. Social security, unemployment compensation, Medicare and Medicaid, public assistance and other social programs are not governmental acts of charity. They represent the conviction of the American people that government must try to prevent poverty and deprivation and that all Americans are entitled to protections against certain contingencies.

Now that structure is threatened, not only by unwarranted cuts, but by an ill-conceived effort to abdicate national responsibility and to foist many of these programs on already financially overburdened states. Fifty years of social progress under the leadership of the federal government is now in danger.

Last year the Congress, through reconciliation, cut fiscal year 1982 entitlement spending under this committee's jurisdiction by $9 billion. The impact of those same cuts in fiscal year 1983 was then calculated to be a reduction of $10 billion. Now President Reagan is asking this Committee to cut another billion in entitlement spending from fiscal year 1982 and another $9 billion in entitlement spending in fiscal year 1983.

Mr. Chairman, let me now outline some of our concerns about the Administration's budget proposals, and the impact of these proposals on specific programs and the people protected by them.

Social Security

In 1981, the budget reconciliation provisions made major cuts in the social security program. These cuts included benefits for dependent children in college or post-secondary schools, minimum benefits for new applicants, offset of disability benefits, elimination of the lump sum death benefit when there are no survivors, and termination of survivor parent's benefits when the youngest child reaches age 16 instead of 18. Overall, social security benefits were cut by $22-26 billion over the ensuing five years.

In May 1981, President Reagan asked Congress for additional reductions. These far-reaching proposals would have severely reduced social security benefits allegedly to deal with social security's financing problems. The hardest hit would have been early retirees - the majority of whom are forced to cease working for health reasons, or because of layoffs. The net effect of these proposals would have been to cut early retirement benefits by 43 percent, disability benefits by one-third and the overall program by 21-23 percent. The impact of these proposed cuts would have been devastating to the program and to those protected by it.

The drastic cuts were met by a tremendous outpouring of public opposition forcing the President to change his position and to appoint a National Commission on Social Security Reform to study and to make recommendations on social security's financing problems. I am a member of that Commission. The President has made no proposals in the fiscal year 1983 budget for social security pending the report of the Commission which is due no later than December 1982. The Congressional leadership of both parties cooperated in this effort by naming ten of the fifteen Commission members. Thus, Congress should not act either through the budget or legislative process until the Commission has made its report.

We are concerned about proposals recently made by leading members of the Senate Budget Committee that, in advance of any recommendations from the Commission, would freeze cost-of-living increases in social security and federal retiree programs. A freeze of the social security cost-of-living adjustment for fiscal year 1983 would cut the benefits of the average retired worker about $324 and for the average retired couple about $468. Even with the cost-of-living adjustment in these programs, inflation already reduces the buying power of the elderly because large parts of their income (private pensions, savings, etc.) are not adjusted for increased living costs. Thus, while it is essentially true that workers' wages have not kept pace with inflation, neither have the incomes of most of the elderly.

The elderly as predominantly a lower income group are particularly vulnerable to inflation. The bulk of their income must go for the necessities of life and for most of them, inflation means a reduction in their ability to buy these necessities. In 1980, nearly 60 percent of persons age 65 and older had incomes below $10,000 compared to only 20 percent of the non-elderly.

Millions of the elderly have incomes just above the poverty line. A $20 to $24 drop in their average weekly income in 1980 would have caused their poverty rate to spurt to more than 25 percent. This underlines the importance of cost-of-living adjustments in preventing the erosion of their retirement benefits by inflation. Many of them are fighting a losing battle even with inflation adjustments. The aged poverty rate jumped from 13.9 percent in 1978 to 15.1 percent in 1979 and increased slightly again in 1980 to 15.7 percent.

Thus the elderly are one of the nation's most economically vulnerable groups. A postponement or reduction in their cost-of-living protection would do serious harm to their already precarious economic situation and would accelerate the increase in the numbers of them being pushed into poverty.

Because social security is separately financed, and because the law requires that all social security contributions be used only for social security purposes, the program should not be used to help to hold down the budget deficit. There is a fundamental difference between a decision in a particular budget year to fund general revenue authorizations at a lower level (such funding can be increased again in a later year) and a permanent change in the benefit protection provided by social security. In the latter case, the recommendation is to permanently reduce, in a self-financed program, the level of protection for which people have worked and paid contributions.

Social security policy should be determined by the purposes of that program and should not be subject to the same kind of modification for budget or fiscal purposes as general revenue programs. This does not mean that some changes cannot be made but it does mean that they have to be carefully thought through, adequately discussed, and not detract from the basic protections of the program. This cannot be achieved through the budget reconciliation process.

The AFL-CIO believes that the social security program should be separated from the general budget and made an independent agency. Only in this way can the earned rights of workers and retirees be protected against the short-term policy swings of the budget process.

Railroad Retirement

The Administration's budget for fiscal year 1983 would eliminate this program which provides railroad retirement, unemployment and sickness insurance. The railroad retirement system would be abolished by turning over the funding obligations ($2.2 billion) of Tier I benefits to social security and by changing the Tier II benefits into a private multiemployer pension plan.

The impact of these proposals on the income security of railroad workers and retirees is potentially catastrophic. Railroad retirement, which is now a uniform national program, could be turned into a multiplicity of programs. Because of the financial situation of railroads varies considerably many of them won't or can't participate in a national multiemployer program and will try to establish separate and less liberal programs. The result will be disruption in the level of retirement benefits for railroad workers and in the collective bargaining process as railroad unions clash with employers over pension issues.

In addition, placing funding obligations of $2.2 billion on social security increases its benefit obligations at a time when this program is experiencing financial difficulties. In any event, the Congress in the 1981 budget reconciliation legislation called for a Presidential study and report on the retirement program. No action should be taken until this report is made.

The Administration would also transfer the railroad unemployment insurance program to the states. Railroad workers would be paid through fifty state programs, many of which pay much lower benefits than the railroad program. This transfer would take place at a time when state unemployment compensation programs are under severe financial pressure. Many are borrowing from the federal government so they can continue to pay benefits. Parceling out of this successful national program to fifty financially hard-pressed states doesn't make sense.

The AFL-CIO is opposed to all of the Administration's proposals on the Railroad Retirement System.

Unemployment Insurance

The protections of the unemployment compensation program, particularly for the long-term unemployed, have been drastically eroded as a result of ill-considered and harsh restrictions initiated by the Administration and imposed by Congress for deficit-reducing purposes. Since 1968 the unemployment insurance trust funds have been included in the unified federal budget. The Administration, therefore, can project outlay reductions in unemployment compensation for fiscal year 1983 as the result of cutbacks already enacted even though the unemployment insurance system is basically financed and administered by the states. To reduce the likelihood of further cutbacks in the unemployment compensation program, we urge Congress to enact legislation that would exclude the unemployment insurance trust funds from the unified federal budget.

As the result of Congressional action in 1980 and 1981, the extended benefit program is severely restricted. The national trigger has been eliminated, and extended benefit claimants are no longer included in the calculation of the state triggers. Long-term jobless workers can now be compelled to take minimum wage jobs regardless of skills and previous wage levels. As the result of two additional restrictions that will become effective on October 1, 1982, extended benefits will be paid in fewer states due to the mandated increase in the state triggers and 20 weeks of qualifying employment will be required for eligibility. Millions of jobless workers in the current recession, therefore, will be deprived of unemployment compensation after they exhaust regular benefits resulting in economic disaster for them and their families. It is estimated that in fiscal year 1983 over 3 million unemployed workers will be denied extended benefits during periods when they otherwise would have been entitled as the result of these changes. These workers will be unemployed as the result of economic events over which they have no control. It is unjust to make them bear the responsibility for their unemployment under these conditions.

During recessionary periods with accompanying high rates of unemployment, labor market conditions are such that the period of job search for unemployed workers is much longer than in prosperous times. In addition, jobless workers who are receiving unemployment compensation benefits exhaust these benefits while they seek suitable employment. Thus, the regular benefit program with a maximum of 26 weeks in most states does not provide adequate protection for workers during periods of recession-induced unemployment.

The official unemployment rate of 8.8 percent seriously underestimates the severity of the unemployment crisis. If discouraged workers who have stopped looking for nonexistent jobs and workers who want full-time jobs but can find only part-time jobs were included, the unemployment rate would be 12.4 percent. Of the 9.6 million workers officially counted as unemployed, only 3.7 million workers are counted in the insured unemployment rate of 4.1 percent. The gap between the insured unemployment rate and the official unemployment rate continues to widen. During the 1974-1976 recession, the gap averaged 3 percent. This differential has increased to almost 5 percent. Because each state's insured employment rate is the trigger for extended benefits, even the present trigger levels are too high. Rather than enacting a one percent increase, Congress should have lowered the trigger. Once the increase takes effect on FY 1983, extended benefits will not be available until the official total unemployment rate is near 11 percent.

In recognition of the necessity for additional weeks of benefits for unemployed workers during economic recession the Congress has several times enacted legislation establishing supplemental benefit programs. In 1958 and 1961, Congress enacted one-year programs that provided supplemental benefits of one-half the regular duration up to a maximum of 13 weeks. As the establishment of these temporary programs lagged behind the need for them, a permanent extended benefit program providing up to 13 weeks of additional benefits was enacted in 1970. This program was designed to trigger on automatically during recessions based on national and state trigger requirements. In response to continued high levels and increased duration of unemployment, temporary programs, providing up to an additional 13 weeks of extended benefits were enacted in 1971 and 1974, bringing the maximum entitlement to 52 weeks. Subsequent temporary legislation increased the maximum duration to 65 weeks through December 1975.

With this historical background, it is difficult to understand how at a time of worsening recession and increasingly high levels of unemployment, the emphasis has been on cutting back rather than enhancing the program established to protect the long-term unemployed. This situation is even more intolerable because jobless workers are finding that other resources are no longer available to them. Tightened eligibility requirements for receipt of AFDC make it virtually impossible for unemployed workers and their families to obtain any welfare assistance when they exhaust unemployment insurance benefits. These workers will also be disqualified for food stamps due to the lowered ceiling on the amount of income a family can earn in order to be eligible. We, therefore, urge Congress to immediately restore the protections of the extended benefit program that have been eliminated and extend the duration of benefits to 65 weeks.

The injustices that unemployed workers are forced to bear are not restricted to the extended benefit program. Recent funding cuts in the Employment Service/Unemployment Insurance administrative budget have forced states to close local offices and reduce the size of Employment Service staff. As a result, recipients of unemployment compensation benefits are faced with drastically diminished services. These reductions began in FY 1981 with the closing of about 400 local Employment Service offices and layoffs of 5000 staff. Still further cuts were to have taken place with the closing of 600 additional offices.

Vigorous opposition by the AFL-CIO and other groups forced the Administration to support a supplemental request to allow the 600 local offices scheduled to close this year to remain open and to cover the cost of the projected increase in unemployment compensation claims processing. However, the Administration's reductions in 1981 have not been restored. Congress should immediately provide funds to reopen the 400 offices that are still closed.

Trade Adjustment Assistance

The crisis for jobless workers is exacerbated by the Reagan Administration proposal to eliminate the cash benefits in the Trade Adjustment Assistance Program (TAA) after July 1, 1982, except for those already enrolled in an approved training program. The objective of this program is to compensate workers who are laid off because of the high inflow of foreign goods. Compensation under this program was severely restricted in the FY 1982 budget as the result of a $1.2 billion cut. This cut was accomplished by changing the benefit levels from the national standard to state unemployment insurance levels, by requiring that all unemployment compensation benefits be exhausted before any TAA benefits could be received and by restricting weeks of entitlement to benefits from both unemployment insurance and TAA to 52 weeks, or to an extra 26 weeks for those in a training program. Prior to this change, the duration of TAA payments alone was 52 weeks with an extension of 26 weeks for individuals over the age of 60.

Because the large inflow of foreign goods is the result of national policy, the joblessness that is attributable to this policy is a national responsibility. We urge Congress to meet this responsibility by strengthening rather than eliminating this program.

Other Special Employee Protection Programs

The Administration proposes to eliminate the Airline Employees and Redwood Employees Protection Programs. However, workers covered by the Redwood Employees Protection Program who lost their jobs on or before December 21, 1978 would continue in the program. Both of these programs were designed to cushion the impact on workers of federal legislation that imposed changes in these two industries. Workers who lose their jobs as a result of federally caused disruptions to their industries are entitled to compensation not only for lost wages as a result of their unemployment, but also for lost fringe benefits, diminished career expections, and obsolete skills. It is unjust to eliminate these protections long after the legislation was enacted and thus forced these workers to bear the responsibility for their federally induced unemployment.

Health Programs

The United States is unique among countries in the western world. It is the only one that does not have a comprehensive and universal national health insurance program. In contrast to other free and democratic nations in Europe and North America, there are 25 million people, nearly 10 percent of the population, without any health insurance -- public or private -- and many millions more with inadequate coverage against the risk of illness. Slashes in federal health programs enacted last year and those proposed this year would add millions of Americans to the ranks of those without health care protection.

Medicare

The Administration has proposed $3 billion in new cuts on top of about $1 billion already enacted in last year's budget reconciliation bill.

The most devastating change would be a 2 percent reduction in reimbursement to hospitals. This cut will have its biggest impact on the elderly and disabled covered by Medicare and the public and community hospitals that serve them. Big city public general hospitals would be particularly hard hit since less than one-fourth of their revenues are derived from privately insured patients. The rest comes from Medicare, Medicaid (which, of course, is also being slashed) and rapidly shrinking local tax revenues. When they can, hospitals will also try to shift the added costs to private patients which could result in an increase in hospital insurance rates for health and welfare plans and other health insurance policies.

Another change would be that claims for uncovered or medically unnecessary hospital services would be disallowed. This sounds reasonable, but it is not easy, in many cases, to know whether a service is necessary or unnecessary until after it is performed. Once again, the extra financial burden would fall on the patients at a time when they are most likely to be financially strapped.

Another modification would require a 5 percent coinsurance charge for home health visits. Home health services are frequently a lower cost alternative to expensive care in hospitals and nursing homes. They should be encouraged. It would be the height of folly to erect financial barriers to this cost-effective form of care and thereby force patients into nursing homes and hospitals.

Federal workers do not currently pay the 1.3 percent Medicare tax because most are covered by the Federal Employees' Health Benefit Plan. The 1983 budget proposals would require all federal employees to pay this tax. With FEHBP premiums rapidly escalating, adding this tax makes the payments federal employees must make for health care far greater than in the past -- in effect, a significant cut in take-home pay.

Of major concern to the AFL-CIO is the Reagan proposal to withdraw first dollar Medicare coverage for employees between the ages of 65 and 69 and to shift these costs to the private health benefits plan at their place of work. Thus even though these workers made the same Medicare contributions as retirees, they would be denied full Medicare coverage. This would be a disincentive for hiring the elderly. Although the purported purpose of the proposal is to bolster the Medicare funds, lessened employment opportunities will mean less, not more, money coming into the Social Security trust funds.

The Administration is also seriously considering a requirement that Medicare beneficiaries pay coinsurance of as much as $15 or $18 a day for the 2nd through 60th days of a hospital stay on top of the $260 they are already paying for the first day of hospitalization. Under current law, the 2nd through 60th days are fully covered. This means a hospital stay of 60 days could cost a Medicare patient more than $1300. The Administration claims that its catastrophic insurance plan would soften the blow, but this is not true. Only 2 percent of the Medicare population would be hospitalized long enough to receive anything from the catastrophic insurance plan. Catastrophic insurance is cheap because so few benefit.

Medicaid

Last year, the reconciliation bill cut the federal share of Medicaid for fiscal 1982 by $1 billion by restricting eligibility for medically needy families and by changes in eligibility for Aid to Families with Dependent Children (AFDC). Just under a million poor Americans were cut from the rolls -- 600,000 of them children.

For FY 1983 the Administration wants even deeper cuts which together with the FY 1982 reduction would mean a slash of 17 percent from the FY 1981 level of services. The proposed FY 1983 cuts would deprive an additional 1.1 million poor of medical care coverage including 600,000 children. Many of them would be cut off the rolls because they would lose their welfare payments and thereby Medicaid coverage for themselves and their families as well. Especially hard hit would be working mothers and their children cut from both AFDC and Medicaid. The rhetoric of the Administration extols work, but mothers are made worse off by working. What many of them fear even more than the cut-off of payments is the consequent denial of Medicaid coverage for their families. The AFL-CIO, therefore, supports enactment of H.R. 5199 which would permit states to restore coverage for the working poor who are deprived of Medicaid when they lose their welfare eligibility.

In addition to the adults and children who will lose their Medicaid coverage when they are dropped from AFDC, coverage for many others would be worsened or eliminated altogether as the result of other Administration's current proposals including:

* Requiring Medicaid recipients for the first time to pay for medical and hospital care. For people below the poverty level, this can mean just one thing -- they will not get the medical care they need when they need it. In many cases, postponed care will result in the end in larger medical costs which will somehow have to be paid.

- Reducing by 3 percent federal matching payments:
  - (1) For so-called "optional" items. The word "optional" is a complete misnomer -- "optional" includes such essential items as dental care, eyeglasses, hearing aids, drugs and medicine and intermediate care.
  - (2) For the medically needy -- people who do not meet stringent welfare eligibility requirements but fall into poverty when they have to pay for the medical care they need.

  Cutting back on federal matching payments will force many states to eliminate both care and individuals they are currently covering.
- Cut off from Medicaid eligibility for those going off AFDC advanced from 4 months to 1 month.
- Permitting states to require adult children to pay the costs of Medicaid patients in hospitals or nursing homes. In many workers' families this could mean a cruel choice between shoes for the kids or keeping grandma in the nursing home. In addition, a lien could be placed on the home of the patient even while still alive so that if the patient recovered, he or she would no longer have a home to return to.

If this gutting of Medicaid is permitted to take place, where will the former beneficiaries go to obtain health care? Public Health Service hospitals served merchant seamen and the armed forces but they were a resource for the poor as well. The PHS hospitals have been closed. Inner city public and private voluntary hospitals already face severe financial problems. Some may actually have to close down. Major health resources have been community health centers in the cities and migrant health centers in rural areas. Both of these programs have been drastically cut. Thus while drastic Medicaid cutbacks are depriving millions of the poor of access to medical care, the alternatives to which they might have been able to resort are also being shut off.

Every American must have the right to needed medical care. The Administration-proposed cuts already enacted are unconscionable. Those now proposed should be firmly rejected. To do otherwise would impose cruel punishment on millions of disadvantaged Americans -- especially elderly, disabled, mothers and children.

Aid to Families With Dependent Children

The cumulative effect of the Congressional Action in the Omnibus Budget Reconciliation Act of 1981 and the regulatory interpretation of the Act have made sweeping alternations in the Aid to Families with Dependent Children (AFDC) program that will profoundly harm poor children and their families. AFDC is the only program explicitly aimed at protecting poor children by giving their families basic income support and nearly 70% of the recipients are children. The program is critical to the survival and well being of millions of children who are among the poorest of any group in America.

The cuts in federal spending combined with the consequent loss in state matching funds are resulting in the denial of the most minimal basic diet and medical care to poor children and pregnant mothers. Additional harsh provisions affecting the AFDC program are punishing the working poor, creating vast pools of forced labor, jeopardizing the jobs of those now working and denying any assistance to needy children of workers who excercise their legal right to strike. Only about half of the states have yet been able to put the changes required by Congress into place making it impossible to assess the full impact on the people affected. It is outrageous that consideration is being given to the enactment of additional measures designed to bring even more pain to the nation's poor.

When President Reagan submitted his FY 1983 budget to Congress he proposed revisions in almost every major support program that offers assistance to the nation's low income families. His budget message urged the nation "...to weather the temporary dislocations and pressures that must inevitably accompany the restoration of national, economic, fiscal, and military health." For the nation's poor, the results of the Administration's budget proposals are far worse than "temporary dislocations." In combination with the program alterations enacted last year in the Omnibus Reconciliation Act of 1981, the FY 1983 budget proposals make poverty a more severe and permanent condition for millions of low income families. The Administration's proposals combined with last year's changes will reduce the incomes of people who are already poor, creating greater difficulty for families trying to secure the necessities of food, shelter, clothing and medical care.

As a result of last year's cuts in AFDC 750,000 families - 2,250,000 individuals - had their AFDC benefits reduced or completely terminated. This year the Administration proposes to eliminate or reduce payments to an additional 921,000 households or approximately 2,763,000 individuals. The effect would be to decrease even more drastically the financial incentive that once existed for families to work their way off of welfare and leave the millions of children in families which rely solely on AFDC with less income with which to supply the bare necessities of life. Combined with cuts in child health programs, community medical care programs, day care, and Title XX -- all of which provided essential supports to disadvantaged children -- these cuts in basic subsistence programs revoke the nation's commitment to providing support and assistance to children in poverty and enhance the likelihood of generational dependency.

The FY 1983 budget proposals affecting AFDC, food stamps, Medicaid, and housing assistance strike directly at the income of the nation's neediest families and individuals. They hurt people who have no other possible source of income: children, the disabled, the elderly, and mothers unable to work -- a total or approximately 14 million people. They make conditions worse for large sub-groups of the poor who are already most disadvantaged: black and rural poor in the south in particular. In all areas of the country, these proposed changes would move people who are already poor even closer to complete destitution.

These are the major specific proposals of the Administration with respect to AFDC, all of which we vigorously oppose.

Requiring states to count energy assistance as income by which the AFDC grant can be reduced.

The whole purpose of trying to ease the pain caused the poor because of the outrageous increase in fuel costs in recent years would be destroyed by this provision. Although energy assistance payments have offset less than a third of the energy price increases incurred by low income families during this period, these same families would now have their AFDC grant reduced dollar for dollar by the amount of energy assistance received. The Administration is also proposing that the food stamp benefits of these same families be further reduced to reflect energy assistance payments causing further erosion of the ability of poor people to secure the basic necessities of life.

Prorating shelter and utilities for AFDC families living in larger households.

This proposal would result in the reduction of shelter and utility allowances to AFDC families which have found it necessary to share housing with other families. The assumption is that they no longer need the full amount of shelter assistance available to a family of their size. The fact is that the current full allotment for housing and utility costs in virtually every state is totally inadequate to provide even minimally safe and decent housing which necessitates the doubling up or families where they can. To penalize these families for doing so is not cost effective -- it's cruel.

Discontinuing benefits to a family when the youngest child reaches 16.

The 1982 budget reconciliation eliminated AFDC for youth 18 to 21 years of age. Now the Administration is proposing to further lower eligibility to age 16. The effect of these provisions is to deny benefits to young people who most need them -- children between 16 and 21 who are attending high school, vocational or technical school or college. Such an exclusion is short-sighted and insensitive. As jobs become scarce, education and training are even more essential for achieving economic self-sufficiency. If generational poverty is to be avoided, children of poor families must have full opportunity to obtain education and skills. It is this opportunity that makes the diffenence between long range dependence and future productivity.

Eliminating assistance to needy families of military personnel.

In its efforts to systematically chip away at the social safety net, the Administration has arbitrarily singled out groups of people to whom assistance will be denied regardless of their need. Last year needy families of workers who were exercising their legal right to strike were denied assistance. This year they propose to add poor families of military personnel to the list of those who will arbitrarily be determined ineligible for assistance.

Cumulative effect on the working poor - removing the work incentive.

Instead of encouraging people to remain in the labor market, the Reagan budget for fiscal year 1982 removed practically every incentive for the working poor to continue working by reducing their income more if they worked than if they simply relied on AFDC and other income support. Further disincentives are created by the FY 1983 budget proposals in both AFDC and food Stamps which in many cases will actually penalize work effort. The impact of this on a poor family can best be illustrated by an example drawn from an analysis done by the Center for Social Welfare Policy.

"Nationwide, the total disposable income of the average working AFDC mother and two children would fall $163 a month. Incomes for working AFDC families would be reduced so much that parents who work would generally be little better off -- or worse off -- than AFDC mothers who do not work. In 24 of the 48 states included in the study, the AFDC working mother earning average wages would end up with less disposable income than the AFDC mother who does not work. In California, the working mother would have $82. a month (or nearly $1,000 a year) less in disposable income than the mother who does not work at all."

As public policy, this reversal of incentives toward work is outrageous. Work efforts of these families should be supported, not undercut. They are the families most on the edge between financial self-sufficiency and full economic dependence. The provision of additional income to them through small AFDC supplements or food stamps is of low cost to public funds, but of high benefit in terms of preventing greater dependency and increasing economic productivity. By fundamentally altering the incentives and opportunities confronting these families, the Administration is reducing the likelihood that they will ever be able to work their way out of poverty or near-poverty subsistence levels.

Mandating forced work and abolishing the Work Incentive Program (WIN).

After restructuring the AFDC program so that people will find it advantageous to stop working in order to better provide for their families, they propose a number of punitive and illogical "remedies" for the situation they have created. They would devise a program whereby a parent choosing to work would have less income than if she did not choose to work, but at the same time threaten the mother with loss of AFDC benefits if she responds to the financial incentive by voluntarily leaving her job.

In addition the Administration seeks to mandate the often punitive and discredited system of "workfare" - whereby parents will be forced to work at make work jobs for no wages with no training and no hope of advancement. Under the optional program provided under last years' AFDC changes, all but five states rejected the workfare option with the vast majority choosing to continue the existing Work Incentive Program (WIN) or an alternative program which includes greater emphasis on training, placement and other supportive services than workfare would provide.

In spite of this overwhelming preference expressed by the states the WIN program is to be completely eliminated with workfare taking its place. It appears that contrary to the constant rhetoric coming from the Reagan Administration purporting to maximize state discretion and authority in the administration of welfare programs, eagerness to punish the poor for their poverty seems to have the higher priority.

The WIN program was specifically set up to provide the necessary training and support services to move adults permanently out of welfare dependence and into non-subsidized private sector jobs. Recognition that the program's goals have not been met has never been matched by an adequate financial investment needed to place the high number of unassigned applicants. Critics frequently ignore the simple unavailability of jobs. In FY 1981 WIN spent $389.5 million to register 1.9 million persons, provide supportive services and training to over 200,000 registrants, place 310,303 in unsubsidized jobs and thereby save $760 million in AFDC payments. Any honest intention to move welfare recipients into self-support argues for expansion of the WIN program - not its elimination.

Making states pay for errors over 3% and reducing funds for state administrative costs.

At the same time the Administation is increasing the complexity of federal rules making it extremely difficult for the states to reduce errors, it is proposing to require the states to reimburse the federal government for all errors over 3% in fiscal year 1983, 2% in 1984, 1% in 1985 and zero in 1986. Such unrealistic error rate requirements make it clear that the proposal is not so much a serious attempt to reduce errors as it is an attempt to shift more of the program costs to the states.

Additional fiscal burdens to the states would result from the proposal to combine the federal share of the administrative costs of AFDC, Food Stamps, and Medicaid and set it permanently at 95% of the federal contribution in fiscal year 1982. There would be no adjustment for inflation in future years. The Administration estimates this proposal would reduce the federal share of state administrative costs in these programs by 12% in fiscal year 1983 and 25% by fiscal year 1986.

Social Services & Child Welfare

An early victim to the retreat by government from its fundamental responsibilities came last year with the brutal reduction of funding and elimination of responsibility for providing life sustaining services to the aged, blind, disabled and young children under Title XX of the Social Security Act. Following Congressional action which turned a major portion of the services program over to the states and cut nearly 25% of federal funding effective October 1, 1981, the Administration impounded an additional 12% of funding which was reflected in smaller checks sent to the states. Most state legislatures had only begun to respond to these cuts as they began their January sessions and the full impact will not begin to be felt until the beginning of their fiscal years on July 1. Day care centers have begun to close, mental health services for young children have been eliminated, services for the elderly and handicapped have stopped and many states have already curtailed all but those services which are literally life-saving. With a monstrous display of insensitivity, the Administration is now proposing an additional 12% cut in Title XX Social Services.

If these cuts are enacted it would reduce the number of people receiving services such as day care and homemaker aid to about three-fifths of the 1981 level, from 7.7 million to 4.4 million. Such short-sighted and cruel economies will have an immediate costly effect on mothers having to leave their jobs to care for their children and the sick and elderly who will require institutionalization because they have been deprived of services which permitted them to remain in their homes.

The next human service program in line for this special block grant treatment is that authorized by the Adoption Assistance and Child Welfare Act of 1980 which was passed by an overwhelming bipartisan majority of Congress. Both Republicans and Democrats recognized that the continued practice of warehousing children in institutions at outrageous state expense and untold human deprivation was a national disgrace and after five years of careful deliberation provided the funds and directions necessary to return these children to family situations. Now, in spite of the overwhelming evidence demonstrating the collective failure to handle this problem, the Administration is proposing that it be turned back to the states with a 46% cut in funding. This will mean that a half-million children will be getting even less of a chance at a decent and productive life than they were getting under the old scandalous state foster care system.

Supplemental Security Income (SSI)

Sparing no one but the wealthy from the vengeance of Reaganomics, the Administration is proposing that more than half of the poor, elderly, blind or disabled persons have their means of livelihood eliminated or reduced. Supplemental Security Income (SSI) provides monthly payments to individuals with little or no other income who are aged, blind or disabled. A little over 4 million of the nation's poorest citizens receive SSI.

Benefits for 2.6 million SSI recipients would be eliminated or severely reduced by the FY 1983 budget proposals. Accompanying cuts in educational, medical, employment programs, vocational rehabilitation, community and social services and food and nutrition programs would close off other avenues of survival for these unfortunate people. The cuts being sought in the Food Stamp Program would result in eliminating or drastically reducing the benefits of 92% of the elderly and disabled recipient households -- with the average loss amounting to $200 a year. It is beyond comprehension how they are expected to survive if these cruel cuts are enacted.

An Alternative to the Reagan Administration's Proposals

Besides stopping the proposed new budget cuts for social programs, an overall economic policy requires addressing the basic questions of jobs and revenues to pay for programs required to meet the needs of the American people. The AFL-CIO has proposed a comprehensive economic approach not only to provide the funds to offset the additional $41 billion in budget cuts proposed for fiscal 1983, but also to provide an additional $23 billion in economy-reviving, job-creating programs. By correcting the main inequities of the 1981 tax law some $31 billion could be recouped.

Specifically we propose:

* Cap the 1982 and 1983 individual tax cuts at $700 per family which would maintain the full reductions for nearly all taxpayers with incomes below $40,000.
* Repeal the leasing of tax credits by corporations.
* Repeal the new loopholes in the oil windfall profits tax.
* Modify the widened estate and gift tax provisions.
* Repeal the future indexing of tax rates.

The President's 1983 budget proposes a $33 billion increase in defense outlays. We reject the Administration's concept of raising defense spending at the cost of vital social programs; of making the poor and disadvantaged, who can least afford it, pay a disproportionate share of the costs of assuring the nation's security.

Instead, we insist that defense needs be carefully scrutinized. If additional funds are justified, they should be financed dollar-for-dollar with a progressive surtax on corporations and individuals levied so that all bear a fair share of the common defense burden.

To create jobs, alleviate suffering and end the recession, we call for a range of investments in people and in the nation's future. We see an urgent need for public infrastructure improvements including sewer, highway, bridge, mass transit, railroad and other essential facilities to reverse the rapid deterioration of communities. Human capital investments must be made through effective training programs and public employment opportunities. The AFL-CIO urges increased investments for low and moderate income housing.

We call for establishment of a new Reconstruction Finance Corporation to start the rebuilding of the economic and urban industrial base that is the economic lifeblood of the nation. We urge a limit to those imports that damage already weakened domestic industries and destroy jobs.

If, in addition, Congress should decide to lower the budget deficit we believe that the best way would be to correct these tax loopholes which in the aggregate would raise some $47 billion.

- Change the dollar-for-dollar foreign tax credit to a deduction.
- Repeal the foreign tax deferral tax preferences.
- Repeal the tax deferrals of the Domestic International Sales Corporation (DISC).
- Repeal the immediate write-off of oil and gas drilling costs and the special depletion allowances.
- Reduce the Invest Tax Credit to its former levels.
- Apply the lower corporate income tax rates only to corporations with profits of less than $100,000.

Our full program entitled "An Alternative to Reaganomics" as adopted at the AFL-CIO Executive Council meeting in February, is attached to this statement.

Mr. Chairman, the AFL-CIO believes that this comprehensive program provides an alternative that recognizes the responsibility of the Federal government to provide for the public welfare and the common defense as well as an equitable tax program that assures that those who are best able to bear the burden of government pay their responsible share. As the Executive Council declared, "This alternative economic program will put the nation on a path to achieve full employment, stable economic growth, fairness in sharing burdens and a society with compassion for those who have too little." We commend the AFL-CIO's program to you for your careful and sympathetic consideration.

Statement by the AFL-CIO Executive Council

on

An Alternative to Reaganomics

February 15, 1982
Bal Harbour, Fla.

The Reagan Administration economic policies, which caused the current recession, must be reversed. This recession has rapidly become the worst since the Great Depression.

The Republican Administration cannot blame anyone else for this recession. The recession was started in July 1981 with Reagan's job-destroying, tight-money, budget-slashing policies. These policies must be stopped. Anti-recession, job-creating programs must be started immediately.

The unfair and excessive tax giveaways of 1981 must be changed to achieve greater equity, pay for the anti-recession program and reduce the runaway Reagan deficits. And the President's second-round budget cuts must be blocked.

The Administration has saddled monetary policy with an unbalanced fiscal policy resulting from President Reagan's huge tax giveaways to the wealthy. This abdication of fiscal responsibility by the Administration places excessive strain on the monetary system and leads to continued high interest rates that further worsen the recession.

The catastrophic economic problems the Administration has created are made even worse by a cruel and regressive ideology which rewards the rich, forgets the jobless, punishes the minorities, ignores the poor and destroys protections for working people, the elderly and the needy.

The President's 1982 State of the Union Message and his Budget Message add up to a total disregard for human needs and for the economic and social costs of high unemployment and recession. Nothing in his proposals will help jobless workers or hasten economic recovery. The President's "new federalism" should not divert public attention from the Administration's blatant failure. The President would thrust basic national responsibilities upon the states, which have historically failed their responsibilities. He would undercut the Constitution and turn America back to the chaos of the Articles of Confederation.

In the year since the Reagan Administration has taken office, adult breadwinners and blacks and other minorities have suffered worse unemployment than anytime since the Great Depression of the 1930s.

Official statistics concede that some 9.3 million men and women are now without jobs. But the true dimensions of the economic crisis are worse than the unemployment statistics.

In addition, another 1.2 million discouraged workers have stopped looking for non-existent jobs. These "hidden unemployed" don't show up in the government's unemployment rate.

Another 5.4 million workers want full-time jobs but can find only part-time jobs. These men and women and their families are suffering from reduced workweeks and reduced income.

Today America has nearly 16 million men and women who are suffering serious job loss and income loss. The real unemployment rate is 12 percent.

During 1982, one out of every three people in the labor force, more than 30 million Americans, will suffer some unemployment.

President Reagan tells us to wait. The Reagan Administration accepts the recession as unavoidable and engages in wishful thinking that a trickle-down investment boom will develop by itself in this depressed economy, even though the government's own statistics show that the business community has no such plans.

But millions of Americans are suffering and cannot afford to wait. Americans need jobs to put food on the table, pay the mortgage or rent and live in dignity.

An Alternative to Reaganomics

Instead of acting to counter the deepening economic decline, the Reagan Administration has cut unemployment insurance benefits, reduced employment and training programs, and welfare assistance at the same time it has destroyed more than one million jobs putting more people on the streets in search of help that's not there. One has to look back 50 years to see such a heartless official reaction to the hardship and suffering of millions of unemployed Americans.

The AFL-CIO calls upon the Congress to reverse these economic policies and set the nation on a path to full employment and balanced economic growth.

OPPOSE BUDGET CUTS

We urge the Congress to reject the newly proposed budget cuts of $41 billion which follow cuts of $33 billion last year. The serious impact of this new budget on workers and the poor is evident in a partial listing:

- Job training programs would be slashed even further from last year's cuts.
- Trade Adjustment Assistance would be practically eliminated.
- Railroad workers' retirement, unemployment and sickness insurance would be eliminated as a separate program.
- Medicare benefits for the elderly and severely disabled would be scaled back,
- Federal employment would be cut by 75,000 over the next two years.
- Federal pay increases would be capped at 5 percent, regardless of comparability with the private sector.
- Retirement benefit protections for federal workers would be lowered.
- Housing support for low- and middle-income families would be curtailed or eliminated.
- Maritime construction support (CDS and Title XI) would be eliminated and operating subsidies (ODS) phased out.

- Mass Transit aid would be cut.
- Railroad transportation funds (Amtrak) would be reduced.
- Educational help to the disadvantaged would be lowered.
- Vocational Education support would be trimmed.
- Student aid and student loans would be cut back even further than last year.
- Economic Development Aid to communities would be terminated.
- Sewer and water treatment support would be postponed.
- Energy programs would be curtailed.
- Energy assistance to low-income families would be cut.
- Child nutrition would suffer further cuts.
- Welfare and food stamp programs would be sharply curtailed.
- Medicaid for the poor would be further reduced.
- Day care, foster care, adoption and child welfare would receive less.

RAISE REVENUES

In order to provide the funds for national priorities and basic protections to workers and the poor, as well as to provide funds for new job programs, the AFL-CIO calls upon Congress to undo the worst aspects of last year's tax giveaways to corporations and the wealthy. We also propose the closing of some long-standing tax loopholes.

Specific changes in the 1981 tax law should:

- Cap the 1982 and 1983 individual tax cuts at $700 per family.
- Repeal the leasing of tax credits by corporations.
- Repeal the new loopholes in the oil windfall profits tax.
- Modify the widened estate and gift tax provisions
- Repeal the future indexing of tax rates.

In addition, Congress should correct these tax loopholes:

- Change the foreign tax credit to a tax deduction.
- Repeal the foreign tax deferral privileges.
- Repeal the tax deferrals of the Domestic International Sales Corporation (DISC).
- Repeal the immediate write-off of oil and gas drilling costs and the special depletion allowances.
- Reduce the Investment Tax Credit to its former levels.
- Apply the lower corporate income tax rates only to corporations with profits of less than $100,000.
- Phase out the special capital gains exclusions.
- Repeal the special capital gains at death exclusions.

Defense expenditures should be scrutinized carefully, and any increases found necessary should be financed by a separate and equitable surtax on corporations and individuals.

CREATE JOBS

The Congress needs to enact a number of programs to provide jobs, alleviate the suffering of the unemployed, and turn around the worsening recession:

- Invest in public infrastructure for the nation's deteriorating communities, including sewer, highway, bridge, mass transit, railroad, and other needed facilities.
- Invest in human capital through effective training of the unemployed and provide public employment opportunities for those who still cannot find work after lengthy searches.
- Encourage low- and moderate-income housing.
- Establish a Reconstruction Finance Corporation to rebuild the nation's industrial base by aiding sectors of the economy and of the country that need special

assistance through loans, grants or guarantees.

- Limit harmful imports that aggravate the impact of the recession and weaken key industries.
- Extend unemployment insurance benefits to protect the long-term jobless.

The Congress should reject the Administration's call for "Enterprise Zones" that would create new sub-classes of citizens and instead, strengthen programs that directly address the problems of unemployment and deteriorating neighborhoods.

The President and the Federal Reserve should exercise their authority to control credit and channel funds to productive purposes, including housing, and to restrict unproductive credit flows for corporate mergers, speculative excesses and foreign investment.

The undue reliance on tight monetary policy, huge budget cuts in social programs, and big tax cuts for the wealthy must be reversed. Tax policy must provide sufficient funds for the nation to fulfill its responsibilities to its citizens, and to provide appropriate balance to the Administration's one-sided monetary economic policy. Budget cuts cannot become an end in themselves -- but should be evaluated in terms of justice and need.

The AFL-CIO is convinced that this alternative economic program will put the nation on a path to achieve full employment, stable economic growth, fairness in sharing burdens and a society with compassion for those who have too little.

###

AFL-CIO Fact Sheet
with
An Alternative to Reaganomics

The Alternative provides for: increase revenues from undoing the worst aspects of last year's tax giveaways, scrutinizing defense outlays and financing any required increases with a corporate and individual surtax, restoration of newly proposed budget cuts, and establishing new jobs programs. It points out ways to raise additional revenues by closing specific tax loopholes:

INCREASED REVENUES

Increased Revenues from Revisions of Tax Law

	Anticipated Revenues (in billions)
Cap the 1982 and 1983 individual tax cuts at $700 per family	$20
Repeal the leasing of tax credits by corporations	8
Repeal the new loopholes in the oil windfall profits tax	2
Modify the widened estate and gift tax provisions	1
Repeal the future indexing of tax rates	--
Total	$31 billion

Increased Revenues from Savings

Scrutinize defense outlays and finance any required increases with a corporate and individual surtax	
Current proposed defense budget increase	$33
Total	$33 billion
Total of Increased Revenue & Savings	$64 billion

An Alternative to Reaganomics Fact Sheet

NECESSARY OUTLAYS

New Jobs Programs

	Anticipated Expenditures (in billions)
Invest in public infrastructure for the nation's deteriorating communities, including sewer, highway, bridge, mass transit, railroad, and other needed facilities	$ 5
Invest in human capital through effective training of the unemployed and provide public employment opportunities for those who still cannot find work after lengthy searches	5
Encourage low- and moderate-income housing	5
Establish a Reconstruction Finance Corporation to rebuild the nation's industrial base by aiding sectors of the economy and of the country that need special assistance through loans, grants or guarantees	4
Limit harmful imports that aggravate the impact of the recession and weaken key industries	--
Extend unemployment insurance benefits to protect the long-term jobless	4
Total	$23 billion

Restore Budget Cuts

Restore Proposed Budget Cuts	41
Total	$41 billion

Total New Jobs & Restoring Budget Cuts **$64 billion**

An Alternative to Reaganomics Fact Sheet

ADDITIONAL REVENUES

Additional Revenue Raising Proposals Achieved by Closing Specific Tax Loopholes

	Anticipated Revenues (in billions)	
Change the foreign tax credit to a tax deduction	$10	
Repeal the foreign tax deferral privileges	1	
Repeal the tax deferrals of the Domestic International Sales Corporation (DISC)	2	
Repeal the immediate write-off of oil and gas drilling costs and the special depletion allowances	6	
Reduce the Investment Tax Credit to its former levels	7	
Apply the lower corporate income tax rates only to corporations with profits of less than $100,000	9	
Phase out the special capital gains exclusions	6	
Repeal the special capital gains at death exclusions	6	
Total	$47 billion	
Total Additional Revenues from Closing Loopholes		$47 billion

###

The **Chairman**. Thank you, Mr. Kirkland.

We operate under the early-bird rule, and, Senator Chafee, you are first.

Senator **Chafee**. Thank you, Mr. Chairman.

Mr. Kirkland, as I read your statement and look at the alternative to Reaganomics which you have submitted, it is as follows in the last three pages: Eliminate all of the defense increases, that is, $33 billion; cuts none of domestic programs as suggested by the President and, indeed restore the cuts of last year; and repeal most of the tax cuts of last year except the 5-percent individual cut that took place in October and the accelerated depreciation. The 1982 and 1983 individual cuts are limited to, I assume, a total of $700 or perhaps this amount for each year, but it simply states, "Cap the 1982 and 1983 individual cuts at $700 per family."

So what you really are proposing, as I understand it, and correct me if I'm wrong, is a return to the situation that existed prior to this administration's coming into office. Is that a fair appraisal?

Mr. **Kirkland**. No, sir; I don't believe so.

As to the defense expenditures, we do not propose the elimination of the defense increases; we propose that they be paid for by an equitable surtax. So, the increase over the old base, the $33 billion in increases, we propose be met by a surtax designed to raise that $33 billion on a fair and equitable basis in proportion to ability to pay.

So we support, in its broad concepts a notion that improvements have to be made in our defense capabilities. We make no judgment as yet on its details as to whether it is too much or too little. We established a committee of the council to make a long-range study of that. And we will be commenting on the components and the concepts behind that budget in greater detail in the future.

We simply say that it should not be financed out of the deficit, that it should not be financed through the curtailment of programs essential to those at the lower end of the economic and social ladder in this country, and that those who have profited the most from the values of this country should not be exempted from it as they were by simultaneously having their income taxes slashed at a time that we are building up defenses.

As to the specific revisions in the Tax Act of last year, as you may recall we opposed that measure last year quite vigorously, and at that time offered an alternative which would not have drained as much of the Federal purse as that bill did.

We do not believe, at a time when this country faces such grievous problems and such serious challenges and has such a backlog of unmet needs, that this is a time to strip the Federal purse, the public purse, of the resources with which to deal with it.

Senator **Chafee**. But you would stick with the accelerated depreciation?

Mr. **Kirkland**. We do not propose the elimination of the acceleration. We do propose——

Senator **Chafee**. As I read your program, it would repeal most of the tax cuts we enacted last year.

Mr. **Kirkland** [continuing]. I don't subscribe to that characterization, sir. A cut of $700 in income taxes per family is a fairly substantial tax cut.

Senator CHAFEE. Would that be cumulative? Would that be a total for the 2 years? Or would that be $700 for each of the years?

Mr. KIRKLAND. $700 each year, sir. And according to our calculations, that would retain the percentage cut up to the level of, I believe, $45,000 of annual income, which covers about 85 percent of the taxpaying public.

Senator CHAFEE. Then, you wouldn't repeal the 5 percent we had last October?

Mr. KIRKLAND. No.

Senator CHAFEE. And you would restore, as I read your program, most of the cuts in social programs made last year, if not all of them?

Mr. KIRKLAND. I think that is a fair characterization, sir. I don't believe that those programs should have been cut last year, and we believe they should be restored. Those were essential programs and vital to those who really shouldn't be expected to bear or are not able to bear the burden of the added austerity that has been imposed on them.

Senator CHAFEE. I notice my time is up, Mr. Chairman. Since we will have another chance, I have no more questions at present.

Thank you very much, Mr. Kirkland.

Mr. KIRKLAND. If I can just comment a little further on that and give you our entire philosophical basis of this, I think it was best reflected in the understanding that we, after a lot of friction with the previous administration, negotiated an understanding on the basis of which we agreed to support and commit ourselves to a program of wage restraint. That understanding was incorporated in a document that was entitled "A National Accord." And the concept of that document was that, in order to combat inflation and to return the country on the road to national growth and full employment, a period of austerity and restraint might be needed.

We were prepared as a trade union movement to go as far as anyone else in our society in accepting and cooperating with a program of restraint, provided everybody else that could, went with us and also bore their fair share of that burden, particularly those who had, as I say, enjoyed to the greatest extent the benefits of our society.

We said at that time, and that was incorporated in that understanding, that the only elements of our society which ought to be exempt from sharing in that common burden of austerity should be those at the bottom of the ladder who didn't have any more notches in their belt and didn't have anything further to give; that, on the contrary, they should be sheltered from that burden and special provisions should be made to help bring them into the mainstream of American life.

I just submit to you, sir, that the approach that has now been underway for a year or so stands that concept on its head, reverses it, and we don't subscribe to it.

Senator CHAFEE. Well, I think you have got some good points in this program and particularly urge you to stress the repeal of future indexing of tax rates. This provision was enacted over my strong opposition, although I must say I didn't muster many supporters. But I think indexing will come back to haunt us and hope you are successful, certainly in this part of your efforts.

Thank you.

Mr. KIRKLAND. I hope you will recall, Senator, that our position on the tax bill was impartial and nonpartisan. We condemned both the administration's tax bill and that put forward by the Democrats in the House and Senate.

Senator CHAFEE. Thank you.

The CHAIRMAN. Mr. Kirkland, following up on the indexing issue, I have a different view, and I don't understand why you take the position you do. As I talk to working people in my State, that's the one provision that they fully understand. They get a cost-of-living adjustment, they end up in a higher tax bracket and pay more taxes. I don't understand why organized labor would not be supporting indexing full blast, unless your concern that effective control over the tax burden is going to put the pressure on Congress to be responsible. In other words, if we don't have the revenue windfall from inflation because of tax indexing, then we are going to have to either raise taxes or stop spending so much money. It would seem to me that indexing certainly ought to be the No. 1 priority of organized labor.

The people who benefit from indexing are the working people, and I hope that we not only keep it but that we convert Senator Chafee and others who apparently haven't focused on it.

Senator CHAFEE. Now, wait a minute. I may disagree, but I have certainly focused on it.

The CHAIRMAN. Well, I mean not properly focused on it; excuse me. I know you have focused on it a lot. [Laughter.]

But I am going to have Dr. Feldstein, who is highly regarded, discuss that at length here one of these days.

You didn't mention monetary policy. Do you have any plans for Mr. Volcker? I don't mean moving plans, but do you have any suggestions?

Mr. KIRKLAND. Well, we have a lot of plans that I wouldn't particularly personalize in the form of Mr. Volcker, who is a very engaging man and a good friend of mine. I disagree completely with the course that he is now on, but I must say that he was undoubtedly appointed with the notion that that would be the course that he would pursue. That process, the appointment of a Federal Reserve Chairman, is an act of policy, and I don't think anybody selected Mr. Volcker with their eyes closed as to what his views were on monetary policy.

I do believe we have for years been highly critical of the independence of the Federal Reserve Board and of its open market committee and the manner in which those policies are made, and we have advocated injecting a little element of democratization into the process and a little representation for those elements of our society who bear the brunt of their abstract manipulation on the basis of their particular economic theories.

The CHAIRMAN. Would you support a looser policy even if it meant more inflation? Do you think the Fed is too restrictive if it means inflation——

Mr. KIRKLAND. Now you are giving me the fallacy of false alternatives, Senator Dole. I don't think it necessarily would be inflationary. I believe that the present policy is inflationary. I believe unemployment is inflationary. I believe that we live in an advanced industrial economy where, in industry after industry that I can cite to you, the cost of hiring money is greater than the cost of hiring labor. And it has always been difficult for me to perceive how you can restrain a cost-driven inflation by driving up the cost of hiring money, when it is a major component of cost. That is true in the housing industry; it is true in the utilities; it is true in the industry that I come out of—the maritime industry.

The opportunity cost of the money tied up in ship construction is a multiple of the cost of hiring the crew. You can lay off the crew, but you can't lay off that bank. And a minor increase in interest rates has a far more significant cost effect than a major increase in wage costs. That is true in a variety of industries.

Furthermore, I always believe, that that equation of supply and demand which is supposed to govern inflation has two sides. I presume, and I surmise that the theory by which tight money licks inflation is by reducing the level of economic activity, and I agree if you put it down far enough nobody can buy anything, there won't be any economic activity, and you won't have rising prices. But I think that's a ruinous way to go about it.

If tight money and its impact on the housing industry deprives us of a million or a million and a half houses that we would otherwise have had, I suggest to you that that aggravates the housing shortage which is the root source of housing inflation in this country. And over the long pull it will have consequences precisely the reverse of those presumed.

The **Chairman**. Now my time has about expired. Is there any single social program, any program at all, where you support cutting as much as 5 cents? Would you cut any program a nickel? Or do you think every program is perfect or underfunded?

Mr. **Kirkland**. Oh, I think there are a number of programs I would cut, sir.

The **Chairman**. Well, we would like to know, because we are looking for candidates.

Mr. **Kirkland**. I would cut DISC.

The **Chairman**. That is in the tax area, and we are going to review——

Mr. **Kirkland**. I would cut the Overseas Private Investment Corporation. There are a few I could find; yes, sir.

The **Chairman**. But it would be helpful to have more specifics. I just can't believe that every social program, because the word "social" is attached to it, can't be scrutinized rather carefully. There is medicare, and we both serve on the social security task force—I guess we meet again on March 26.

Mr. **Kirkland**. We just can't go on meeting like this.

The **Chairman**. Well, we are going to meet up here, too.

So it would be helpful to have your recommendations on the spending side, because we are doing what you suggest in the last page of your statement. You listed a number of tax expenditures that you think should be addressed—leasing, for example. As I understand, you are advocating outright repeal of the leasing provision.

Mr. **Kirkland**. Yes, sir.

The CHAIRMAN. And that, in my view, should either be repealed or sharply modified, and it's a view widely held in this committee. So we are taking seriously your recommendations.

But if there are areas on the social side where you think we could tighten up, we really are looking for candidates.

Mr. KIRKLAND. I do not believe, sir, and I repeat what I said before, that at a time like this—we are in the middle of a recession, a serious recession—the circumstances that people face in this country—working people, people on the bottom of the ladder—are such that that ought not to be the area which we attack as the means of dealing with the Federal responsibility in our society.

I think that circumstances of a modern industrial society impose greater burdens and a greater responsibility on the Federal Government in this day and age. I assert that, I believe that, and that is our position, sir.

The CHAIRMAN. Well, I share that view, too. I don't want to be misunderstood. I am not talking about wringing it out of people, the low-income beneficiaries, but their providers, and some of the administrative costs; we are looking at hospitals, physicians and others who do quite well under medicare, for example. And I believe we ought to focus on some of the people other than those who receive food stamps and WIC programs and AFDC payments. So that is the area that I suggest that we may have some common ground.

Mr. KIRKLAND. Well, I think there are areas in that. We do not believe that the structure through which we reimburse the providers of medical care is adequate. And we also believe it is excessively inflationary and does drive up costs and that alternative means of controlling those costs ought to be pursued. And we have taken that position consistently.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. Thank you, Mr. Chairman.

May I welcome Mr. Kirkland and his colleagues and make a point which would interest them and should be noted by this committee?

You are here representing the members of the AFL-CIO and working people generally, yet you have devoted a very considerable portion of your testimony to the concerns of some 10 million women and children who are dependent, who are persons receiving assistance under the AFDC program, part of the Social Security Act.

This committee is in a serious way the trustees for those children. This administration has savaged them, and plans to savage some more. Senator Packwood, our distinguished ranking Republican member has said that the administration is turning on all women who work for a living in the marketplace, but it literally is declaring war on women on welfare who work. And they make it very clear that they give these women the alternative to be completely dependent on welfare or have no assistance of any kind whatever. That is the choice the administration wants them to make.

To be completely dependent is the only choice they can seriously make as mothers—to continue working costs money. They go on welfare, and they will be the object of yet another series of tales about an orange and a bottle of vodka.

Mr. Schweiker was here the other day, going on in some way that I found confused about AFDC mothers and the Government paying their union dues. They are not union members; and few of those children, one-half of whom are under eight, are union members. But he said somehow we are paying their dues.

Mr. KIRKLAND. I believe that more and more union members in this recession are being forced on welfare because of the termination of extended unemployment benefits, and they don't do it gladly.

Senator MOYNIHAN. Right, but it happens. I have another question I would like to put.

Sir, it seems to me if there is one defining characteristic of American public life in the last generation it has been that our trade union movement, in contrast to almost every other such movement in the world, has been solidly supportive of the necessary defense expenditures of our Nation, and has been solidly supportive of international trade. You could almost describe America's position in the world as being one that the American labor movement has made possible; that is, a strong military and an openness to international trade. Those are our two central policies. Without them we would be a profoundly different country. Look at any country where the labor movement has its normal position, which is to be against defense spending and against international trade.

I don't want to be too sweeping in that characteristic, but certainly this has been the position of the AFL-CIO. And you have warned, over the last year and a half, that you could be driven out of that position. But nobody has heard you or nobody has thought what that would mean.

You say today that the administration's 1983 budget proposes a $33 billion increase in defense outlays, and you reject the administration's concept of raising that money by taking it away from social programs. You say, if it is a choice we have to make between the direct interests of our people, we won't make it.

You also mentioned the proposed elimination of the trade adjustment assistance program didn't deal with the question of trade and trade agreements. Two years ago, this committee and this Congress, adopted the Tokyo Round, a new and major trade agreement, because the AFL-CIO came up to us and said, "We are for it, if it is accompanied by trade adjustment assistance such that those poor workers who are put out of work as a policy of the U.S. Government are allowed unemployment compensation and retraining. Indeed, the workers lose their jobs in consequence of an agreement we make in some other capital to cut our tariffs and the price income of the goods. It's the Government's policy that they should lose their work; it should be Government policy to find them new work."

Now, this present budget proposes to abolish trade adjustment assistance altogether—altogether—following last year's cut of close to 90 percent.

Had you known this would be done, would the labor movement have supported the Tokyo round? That this agreement would be made with you and then broken? And if it continues to be broken can you support the next proposal on international trade?

Mr. **Kirkland**. The answer to that is negative.

I recall the matter vividly, since we were involved deeply in all of the discussions leading up to that. I recall speeches on this floor. I recall editorials in our leading journals of opinion in this country. And I recall academic argument to the effect that free trade must be maintained at all costs but that those costs shouldn't be imposed unfairly upon the innocent victims, and the way to deal with that was generous—generous—trade adjustment assistance.

Yet, I would have to say, sir, somehow I always knew, something within me told me, that as soon as the consideration for that understanding had been achieved——

Senator **Moynihan**. Your support, without which there would have been no agreement.

Mr. **Kirkland**. Yes. That as soon as the consideration for our support began to cost money, that it would come under attack, and probably from some of the same sources that during the earlier part of the debate came forth as leading advocates of generous trade adjustment assistance, not trade adjustment assistance restricted and defined and narrowed and conditioned, but generous trade adjustment assistance.

That has come to pass. The same journals that advocated in editorials their enthusiasm for liberalization of trade led the pack in denouncing the heavy costs of trade adjustment assistance and the fact that some workers were drawing this money and that it was 80 percent or so of what they would have made for working, and isn't that awful? The fact that they would rather be working and couldn't work was ignored, and they became alluded to as parasitical, in effect.

Senator **Chafee**. Gentlemen, we have got a tight schedule here. We have to quit by 12 p.m., because of the rule of the Senate. We still have five other witnesses and, therefore, must restrict the interviewers. I hate to cut in, but we have others waiting.

Mr. **Kirkland**. We do refer to this in our testimony, sir, and advocate the restoration of trade adjustment assistance.

Senator **Chafee**. That fact and the rest of his testimony is on the record.

Senator Bentsen?

Senator **Bentsen**. Thank you very much, Mr. Chairman.

In reference to tax indexing that was made earlier, I want to say that I am very much in accord with Senator Chafee's views on that and voted against tax indexation.

I can't help but remember that with the Joint Economic Committee I sent some people down—I think it was in 1973—down to Brazil. That is a primary proponent of tax indexation. And they said, "Don't fall into this trap." And the two countries that are the primary proponents now of tax indexing are Israel and Brazil. Both of them have suffered triple-digit inflation. It just doesn't work. It's a copout.

The other point that was made earlier was the question about monetary policy. I don't want to go back to opening the floodgates of credit, but I sure think we can have a moderate, stable increase in the money supply. Anytime that you have under 70-percent utilization of capacity and you have got 8.8-percent unemployment and you are in a deep recession, then surely you can have a moderate increase in the money supply.

And yet the Chairman of the Federal Reserve, when he said he was going to expand credit last year, 3½ to 6 percent on an M-1 basis, came in at 2.2. And you had a wild gyration. You had a contraction in the second and third quarter, and you had a 12.6 increase in the fourth quarter. And that just doesn't add up to anything like bringing down interest rates; it holds it higher than it should.

Now, Mr. Kirkland, I have pushed very hard for accelerated depreciation, because I thought we had to increase productivity in this country. And I think that was a step forward. I didn't agree with the 10-5-3 as much as the one I helped draft on the previous bill, which I thought was a fairer one, actually, but the thing that is being neglected now is the human factor insofar as productivity.

You see the administration talking about $2.4 billion for training to replace CETA, but that focuses on the worker 25 years and younger. And with the trade adjustment assistance going out, if that happens, then you are not going to have anything to train them to—worker. And of all the developed nations in the world, none has been more neglectful of that. And with some industries going down, obviously, and other industries increasing, we have to have the training done to get those mature workers over into these new jobs in order that we can be productive. And that is apart from the human suffering and what happens there; that is just in the productivity of our country.

Don't you think that it is time that we have a program that will take care of the mature worker also in the transfer of skills and the new skills that have to be learned? Would you comment on that?

Mr. **Kirkland**. Yes. I would like to comment on what you said in the beginning as well as the precise question.

I think it is always useful to go back and see why things were done and why structures were built before you start tearing them down. I would like to point out an iron law that all problems are caused by solutions, and the process of solving problems is an unending one. And the process of undoing solutions can bring you back to the old problems, so it pays to look at those problems.

You talk about indexing and those entitlement programs. Well, I have sort of a recollection that that policy and that departure in dealing with the needs of retired citizens was advanced by rather conservative people. It was a good Government move; it was designed to depoliticize the social security system, because the problem which it addressed was the fact that every couple of years the House Ways and Means Committee and the Senate Finance Committee tended to report out an increase in OASI benefits, which, I believe, if you check back over time, you would find that they tended to exceed the increase in the cost of living. And it happened to be in election years.

So this was an exercise in civics. It was a good Government, rather conservative move to depoliticize the OASI system. And now we want to do away with it. Well, if you do away with it you will go back to the old system, I presume, and go back to the old problems.

The same is true of CETA and public service employment. I believe if you search the Congressional Record you can find eminent men of a conservative persuasion during that period when Washington was burning and Detroit was burning and Los Angeles was burning——

Senator **Bentsen**. Of course, I was referring specifically to tax indexation.

Mr. **Kirkland**. Well, I think that could be addressed in the same way. The taxes are going to be reexamined from time to time and cut. The question is, do you do it on an ad hoc basis, on a basis whereby you have the opportunity to examine the needs of the country at that time under a fair distribution of the burdens and make that appraisal under the conditions that exist?

Senator **Bentsen**. Well, frankly, I think that is the better approach.

Mr. **Kirkland**. I do, too. I do, too.

Senator **Bentsen**. But the main thrust of my question is the question of training of the mature worker.

Mr. **Kirkland**. I think the human resources of this country ought to be cultivated without respect to age, race, sex, creed, or color, and I think any opportunity to move out of a depressed condition of life ought to be extended without respect to those factors.

In our society I think the aging are going to be a larger and larger component of it, and if we neglect that resource and assume that they are not a good resource for training and upgrading of skills we will be depriving the country and our society of a great potential asset.

The **Chairman**. Senator Long, then Senator Heinz.

Senator **Long**. I just want to talk briefly, because of the time limitation. I would like to talk a lot, but I just want to commit myself to one thing today.

As best I can make of it, Mr. Kirkland, I can't see where anybody has shown us on this committee where we come out on any acceptable basis on our trade program. I can recall sitting here for years thinking that men like Walter Reuther, who was supporting a liberal trade policy, would go on to be compelled by the trend of events and change their position. Of course, he is gone, but his successor sees the problem.

I have heard some economists explain to us about all of these different industries that are labor intensive, where we are going to have to get out of them because other people around the world have a lower wage standard. And I hear the conversation that we must be more of a service-oriented country.

I am sure that some of these services would be nice, if we can do it; for example, if we can provide banking services to other people. But I always found myself going to other countries and finding that it doesn't take them long to catch on how to do banking, for example; that all things considered, if the wage is adequate, that's nice work. Anybody with a modest amount of education can count money and put it in the till and pay it back out, just to take one example.

Now, you've got some economic advice of people of your choosing, who I'm sure do a good job for you. Have all these people been able—that is, business that consults with you and labor and others—have they been able to show you that the policies we are pursuing in trade are going to enable us to have a balance? Is it anything as favorable as just a balance of trade, where we earn our way by selling commodities that we are producing or selling services that we are producing?

Mr. **Kirkland**. Well, I have never been convinced of that, sir, and I have never heard any argument that was satisfactory to me. I agree with your description of the argumentation. And I guess not too long ago there were people saying we ought to get out of many of these industries where other countries have a labor-cost advantage and concentrate on things like microchips. Well, I see we are not going to do it in microchips, either, because they are doing it better. So now it's services.

Well, I come out of a service industry; I come out of the maritime industry. And fellows that go to sea for a living would love to see a little emphasis on their particular service industry, but I'll be damned if I see it. That industry is going down the chute. It barely exists anymore, and we are getting all our services not from conventional seafaring nations but from nations who simply sell their flag to Americans.

In the labor movement, you know, we pledge allegiance to the flag of the United States. Well, we've got corporations in this country that pledge allegiance to the flag of Liberia.

Senator **Long**. It seems to me that there are so many erroneous assumptions and erroneous conclusions built into the trade program that we are pursuing, that I would hope that at some point those who are advocating it and those that are trying to administer it would undertake to try to show us with such support as they can find from the multinational corporations and others who like it that way how we are going to come out on that. Because the best I can make of it now, we are running a deficit in our trade, and we are making it up in balance of payments by selling America. In other words, we are selling them our forms and our factories and our office buildings.

Now, no other country would be so foolhardy as to pursue that kind of a trade policy. Eventually, I guess, we would have to go to work for the Japanese. In fact, in some respects we are doing it now; but eventually, I guess, we would all be working for the Japanese or the Germans or whoever has enough good judgment to keep their own nose above the water and to be productive.

So far as I can see, nobody is counting what it costs us to subsidize our exports enough to pay our way. Now, when you are buying something where you are going to have to pay off one way or the other, where you respect their right to buy your real estate, your stockmarket, everything over here, when you respect their right to do all of that it seems to me at some point somebody had better compute what those imports are really costing us in terms of what it would cost us in order to find enough services that we can export that would make it back.

Now, when you start trying to figure out how you are going do it, it looks to me as though it's a lot cheaper to subsidize some of your own services such as the merchant marine that you mentioned, to make it up to yourself that way, even though it costs you more theoretically, than to make it up if you look at what it is going to cost you to subsidize sufficiently to put your commodities in the other fellow's market.

But I just wondered. I thought maybe that they had at least shown you something that they hoped would be credible, to persuade you that in the end those whom you represent—the rank and file of American labor—were going to be able to get some jobs back out of this enough to where we could pay our way.

Mr. KIRKLAND. Senator, I share your description of the predicament, and I share the sentiments that you expressed. We are afflicted by a simple fact: capital is mobile and labor is not.

Other countries can put up barriers, and capital can leap them and in fact exploit those barriers to our disadvantage and leave the workers behind.

I don't subscribe to this notion that these things happen on the basis of pure comparative advantage. I think we export comparative advantage and have been doing it for some time. You look at much of the modern robotics that are used in Japan, and if you examine them closely and look at the manufacturer's plate you will see American patents on them. Our companies are selling that capacity rather than doing it here. You won't see that machinery installed in this country.

I believe that some critical components of that very fast, new French railroad are American patents. They are not on any railroad in this country. Those things happen in those countries not by virtue of the unseen hand but because there is an industrial policy in those countries designed to achieve that result.

People are running around now, and it has become very fashionable to imitate or advocate the imitation of Japanese styles of management or the organization of work in their factories. They ignore one simple fact that I think has a lot more to do with the result than any of those things which are manifestations of a different culture and a different society, and that is that Japanese interest rates are about one-half ours.

Now, theory tells me, somehow, that if you have lower interest rates in another country you are going to lose all of your capital; it's going to flow out. Somehow it doesn't leave Japan. They seem to have some capacity to maintain those interest rates at about 7 or 8 percent. I think it is worth examining how they did that, how they accomplished that economic miracle. I suspect it wasn't an unseen hand; I think it's managed that way.

Now, I believe that if we could do that, this country would embark on a boom, if we could get those interest rates down to that level. There is pent-up demand in this country. If you could get interest rates down to 7 and 8 percent you would have a housing boom, and all that follows from that, and this country would then turn around.

Senator LONG. Thank you very much.

The CHAIRMAN. I just note, before I recognize Senator Heinz, that of course the Japanese save money, too. They have a savings rate of about three or four times ours, and they have a big pool of private savings to finance their debt; so they therefore have lower interest rates. But we built a lot of things into that tax package on savings.

Mr. KIRKLAND. Well, Senator, assuming that's the case, no matter how much they save, if they can put that money in the United States and get 18 percent for it, why don't they? It doesn't happen. It stays in Japan, and they get 7 percent or 8 percent for it. I suggest that is no accident. That is the result of deliberate policy and controls that bring that result about.

The CHAIRMAN. Senator Heinz?

Senator HEINZ. Thank you, Mr. Chairman.

Mr. Kirkland, one of the proposals in your statement is to limit harmful exports that aggravate the impact of the recession and weaken key industries. That's on page 2 of the attachment to it.

As you know, there is a lot of concern in Congress about what imports are doing to the steel industry, to garments and textiles, particularly from some of the "newly-industrialized countries" as we call Korea and Taiwan and Hong Kong.

You know, we in this country believe in an open-trading system, but one that's fair. We believe, I think fundamentally, in free but fair trade. It seems to me, correct me if I am wrong, that the Trade Agreements Act of 1979 which liberalized world trade—it had paraproductions in this country that were supposed to go hand in hand with paraproductions in other countries, had subsidies codes, the dumping codes, the procurement codes—my recollection is that the AFL-CIO supported the 1979 Trade Act Agreement. Is that right?

Mr. KIRKLAND. With qualifications, I think that's right.

Senator HEINZ. Now, as I understand the qualifications, there were some very real qualifications, and they included a commitment to adjustment assistance and to the administration of what we call "the escape clause," section 201.

Mr. KIRKLAND. That is correct. Expedited process by the Trade Board.

Senator HEINZ. That's right, both of those programs, with very different mechanisms. One helps workers and firms. If the workers are laid off, you can get some trade readjustment assistance, kind of an unemployment payment. Section 201, the escape clause, gives industries time, gives them shelter of a temporary nature from a surge or from a catastrophic problem within imports.

I think most Members of Congress, like yourself, supported liberalization of trade in general, on the assumption that those adjustment mechanisms would be maintained and would be in place; and, second, that as we lowered our barriers to trade others would do likewise.

In your judgment, having mentioned trade adjustment assistance, the use of the escape clause, and the extent to which others have engaged in the reciprocal opening of markets, would you say that any of those three commitments have been maintained.

Mr. KIRKLAND. No, sir. They have all been violated. I think this country is playing one game and the rest of the world is playing another one. They all use the same labels. I go to a lot of international meetings, and I hear eminent statesmen from many of these countries make the usual free trade speeches and denounce protectionism, and simultaneously they engage in it.

Senator HEINZ. How long could we ask the working people of this country to support a free trade policy and say "No" to protectionist policies as bad as the ones that we criticize in Japan or in the Common Market, as long as there is no American policy aimed at getting reciprocity? Having an effective escape clause—201, the adjustment program? Or having a good TRA program? Having all three of those? How long can we ask the working people of this country to just be patient and support this theoretical macroeconomic concept of free trade which is not a two-way street?

Mr. KIRKLAND. That time has already passed, Senator. In fact, the truth is that our affiliates and the AFL-CIO itself clung to free-trade concepts long after the membership had become alienated from it, because they see the consequences and they see the real world right where they work and live.

We were forced to change our perception of this problem by what came up from the ranks. In meeting after meeting, convention after convention, this became the most hotly-debated issue. We slowly and reluctantly departed from the assumption that these theories are working in practice or that they are universally acknowledged, and we have come to the view that we are playing one game and the rest of the world is playing another. The game that the rest of the world is playing is managed economies and mercantilism. They continue to call it "free trade"and they continue to denounce protectionism, but I explored this once with one of them and asked him what he really thought "free trade" meant, and he said it meant access to the American market and that's what it does mean to them, pure and simple.

I think we ought to use that access to the American market, which is our greatest leverage in these relationships, to achieve the results that more neatly fit the assumptions.

Senator HEINZ. You know, you mentioned using our leverage, and you mentioned your background with the Seafarer's Union.

Mr. Chairman, I will be brief and take 45 seconds.

We had a hearing last week where a gentleman from Pennsylvania—Colonial Beach—had been trying to export beef to Japan. Japanese love our beef. They had had an experience a year or so before with a trade promotion device called a "boatique"—a boat loaded with beef and other American products.

The Japanese said, "I'm sorry, you can't come to Japan. We just don't want that boat and people going in and buying beef and walking out." I think it was the longshoremen over here who heard about that. They sent a message to the Japanese. They said, "We heard what you said, but if that boat doesn't land there and if that doesn't take place it is going to be very difficult, very difficult indeed, for any Japanese ship any place in the United States to be unloaded."

Two days later there was an invitation, just opening the doors, open arms, welcoming this boatique to every port in Japan. I think there is a moral there.

Mr. KIRKLAND. Well, I think so, too, sir. I think we have to resort to those attention-getting devices, not on an ad-hoc basis, but I think as a matter of Government responsibility and Government policy. It seems to be the only thing that works.

Senator HEINZ. I totally agree.

Mr. Chairman, thank you.

The **CHAIRMAN**. Senator Bradley?

Senator **BRADLEY**. Thank you, Mr. Chairman.

Mr. Kirkland, it seems that we had a meeting here about 2 weeks ago when Senator Grassley made a reaction that I thought was particularly interesting. He said, "When is the Fortune 500 going to make the President's program work?" You have the UAW giving in; you have the auto companies giving in; and his point was that somehow or other, somewhere on the way to the promised land, the Fortune 500 had strayed the path.

Is that the way you would characterize it? Or do you think that the blame is not really with the Fortune 500 or with the AFL-CIO but maybe with the Government?

Mr. **KIRKLAND**. Well, Senator, I think we have made our views known on the policy that is in question, rather abundantly; that is, to the reaction of big business, the financial and corporate community in maintaining silence and in helping organize support for that policy while the tax cuts were going through, from which they benefited so handsomely, and then after it is all in the pocket finding fault and picking out the flaws in this program as they have.

It reminds me of a scene from an old movie called "Casablanca," where the Gestapo ordered the French prefect of police to close down this establishment, the bar, which had a gaming room in the back. And the prefect of police went to the establishment that evening, as was his custom, played roulette, won as they permitted him to do regularly, emerged into the barroom, blew his whistle, and said, "This establishment is now closed, indefinitely."

The proprietor came up to him and said, "Louie, what are you doing? Why are you doing this?" And simultaneously the employee came out of the gaming room with a wad of francs which he slipped to the prefect of police, and he stuck it in his pocket and said, "I'm shocked—shocked to discover that there is gambling going on in this place."

They took the proceeds of the riverboat gamble, and they've got the money, and now they're indulging in a spasm of honesty and candor. [Laughter.]

Senator **BRADLEY**. The committee is going to be considering some form of trade legislation. There are a variety of so-called reciprocity bills on the Hill. What I would like to know is if you would generally prefer reciprocity, legislation, which takes a bilateral approach, or would you prefer tightening up the existing multilateral mechanism under the General Agreement of Trade and Tariffs? In other words, would you prefer making the multilateral recourse to relief stronger versus the introducing a bilateral approach with reciprocity legislation?.

Mr. **KIRKLAND**. Senator, I would approach both. I don't think they are exclusive, with regards to the General Agreement on Tariffs and Trade and the multilateral agreements in institutions.

The greatest weakness from our standpoint is the total absence of any consideration of social and humane criteria. And we, together with our colleagues in other trade union centers of the free world, have advocated the inclusion of what is known as the social clause; that is to say that in order to avail oneself of the advantages of the GATT, every country ought to commit itself to the obversation of certain minimum standards including freedom of association, which is a universal instrument of the International Labor Organization, widely violated throughout the world, minimum standards of health and safety in the manufacture of their products, and other conditions, not at our level but at a decent world minimum level along the lines of the standards of the ILO. I think that ought to be pressed, and I think it is in our national interest and ought to be our national policy to press that in those forums.

But I think the effective attention-getting devices that I discussed with Senator Heinz—there is much that can and ought to be done in terms of our bilateral relations.

If we are going to achieve fairness, we are going to have to have means of affecting another country's interests. I do not think that they respond to philosophy or theory; I think they respond to interest. And I don't think we are going to have much leverage or are going to be able to be very persuasive with these countries unless that is reinforced by a capacity and a willingness to affect their interest, and their interest is access to the American market. And I think we ought to use it.

Senator **Heinz**. Would the Senator yield for a comment on reciprocity?

I believe it's not really fair at all to the reciprocity measures that have been introduced to say that they all seek bilateral solutions. Indeed, my preferred solution through the use of reciprocity legislation would be, for example, to get the Japanese to open their markets not just to us but to everybody, because in that way we can expose them to the cold hard wind of competition, keep them from building up their infant industries until they march 25,000-strong upon the rest of us and wipe us out.

It is in our best interests to use our leverage, not just for our own selfish interests but to open up other markets for all.

Senator **Bradley**. So your view of the reciprocity legislation is that the U.S. Government should use it to pressure the Japanese to open their markets to the Germans?

Senator **Heinz**. First for us, and also for others.

Senator **Bradley**. All right.

Mr. Chairman, could I ask this one quick question?

The **Chairman**. Well, I will just say we have five additional witnesses, and we hope to complete by noon.

Senator **Bradley**. Mr. Kirkland, given the state of the automobile industry, and given how much they have a stake in small automobiles, and given where the oil price is going and therefore the gasoline price—decreasing—and given the fact that we have multiyear deficits of enormous proportions, and given the fact that some banks are on the verge of failing, could you see your way clear to support an oil import fee that would also move toward breaking OPEC?

Mr. **Kirkland**. I believe that the problem of our reliance on energy controlled by OPEC requires an approach that we recommended in 1974 immediately before the oil embargo was lifted. We missed a great opportunity at that time to bring some reality into it and to begin to liberate ourselves from that situation. And it ought to be dealt with as a package.

I don't think that the interests of this country are adequately represented in dealing with a foreign state-controlled cartel or monopoly by leaving it to our private companies who have a foot in both camps to represent us. So we advocated at that time that the Government should take over the purchasing of oil and the allocation of it through blind bidding. I think that's just as good an idea now, and I think it's more likely to work at a time when there are these growing pressures on OPEC. I think we ought to exploit them, because in the long run it is not in our interest to have that arrangement continue.

We supported and advocated at that time a substantial tax on gasoline, which would then be allocated to mass transit and some major investments in the mass transit system of this country on a large scale, and on energy conservation, and on rebates to those who had no options and no choice as to the extent of their use of gasoline, including going to work.

We have sort of changed our views on the tax thing because of the fact that no progress whatever has been made. And we have become, I think, despite the use of the declining imports but because of a recession, more dependent than ever in a real sense. We haven't done anything about improving our capacity to transport people other than by passenger automobiles. If anything, we are more dependent on automobiles.

I don't think we have even dealt with the problem. I don't think it is resolved by a simple import fee; I think it takes a more comprehensive program.

Senator **Bradley**. Thank you.

The **Chairman**. Mr. Kirkland, thank you very much for your testimony, and we would appreciate it if in fact you could comment on some of the areas that we have suggested.

I have just one last question. I assume you would hope that there should be some bipartisan approach to a solution and that we ought to do it very quickly. Do you agree with that?

Mr. **Kirkland**. Well, sir, I am more interested in the nature of the solution than the mere fact that it might be bipartisan. I would not like to see a bipartisan approach to a bad solution.

The **Chairman**. Right. Well, make it nonpartisan, then.

Mr. **Kirkland**. Right.

The **Chairman**. Thank you very much.

Mr. **Kirkland**. Surely.

The **Chairman**. Our next witness is Mr. James Hacking, legislative counsel, American Association of Retired Persons/National Retired Teachers Association, Washington, D.C.

Mr. Hacking, first you might identify those who have accompanied you, and, second, your entire statement will be made a part of the record. We hope that you may be able to summarize the statement so we will have some time for questions and still meet our deadline.

Thank you.

STATEMENT OF JAMES HACKING, LEGISLATIVE COUNSEL, AMERICAN ASSOCIATION OF RETIRED PERSONS/NATIONAL RETIRED TEACHERS ASSOCIATION, WASHINGTON, D.C.

Mr. HACKING. Thank you, Mr. Chairman.

On my right is one of our legislative consultants, Marty Corry; on my immediate left is one of our legislative representatives, Laurie Fiori; and on my far left is one of our economic consultants, Mr. Ralph Borsodi.

I will do what I can to summarize our statement. The statement itself is quite lengthy and does cover all of the items that fall within this committee's jurisdiction.

In the opinion of the associations, which now have, as I am sure you are aware, in excess of 13 million older persons as members, the Nation faces an economic and budget crisis of unprecedented complexity and nearly unprecedented proportions.

Over the past decade a number of extremely dangerous economic trends have severely damaged the economy's health. Over this period the rate of inflation has tended to rise over time, reaching a maximum of 13.3 percent in 1980. At the same time unemployment has been very high and tending to rise under the influence of the recession of 1974 and 1975, the recession of 1980, and again the recession of 1982.

Also, the rate of growth in real GNP and real wages has tended to decline over time. The combination of these economic trends have taken their toll on the Federal budget. Basically, inflation and other related economic trends at certain points have tended to drive up program spending, while still other trends have tended to dampen revenue flowing into the budget that would otherwise have been there to help pay the costs of these programs.

It is clear from the surveys that we have done over time, surveys of the elderly as well as the nonelderly, that inflation is the chief economic concern of older persons. It transcends everything else. Older people want the rate of inflation brought down and kept down at rates that people can live with—not 10, 8, or 6 percent, but more like 2 percent a year.

The administration has sent up a budget to the Congress which, because of the combination of the effects of the recession, last year's very large tax cut and the planned 18-percent increase in defense spending, could result in a budget deficit for the next fiscal year of anywhere from $93 to $125 billion. In the absence of a return of robust economic growth, the budget deficits for the fiscal years 1984 and 1985 could be even larger.

We know from our visits to Capitol Hill that this budget has created a great deal of consternation, if not outright panic. It has certainly created a lot of panic in the financial community and among the public at large.

This kind of reaction has, in turn, generated a whole series of proposals in the Congress to slash cost-of-living adjustments in the entitlement programs, and make drastic reductions in other basic entitlement programs like medicare and medicaid on which the elderly, through no fault of their own, have come to rely.

As far as the associations are concerned, we want the Federal budget deficit brought down and that budget ultimately brought into balance. We take that position for two basic reasons: The first is that it makes good economic sense to do so. Fiscal policy is definitely out of sync with monetary policy. We think that bringing the budget into balance and maintaining that balance over the business cycle is one of the necessary elements in any kind of a comprehensive anti-inflation program.

At the same time we know that if these kinds of budget deficits that are now projected actually begin to materialize they will generate more and ultimately irresistable pressure to make drastic cuts in cost-of-living adjustments in the entitlement programs. COLA's have been singled out as an easy target to achieve very substantial savings quickly and make the budget deficit look better.

The associations have consistently, flatly opposed proposals to cut back cost-of-living adjustments in the entitlements. Some proponents of such cutbacks say the elderly have not suffered too much in terms of financial pain. We think they are not aware of the pain the elderly have really suffered.

Over the past decade, the Government expanded programs to reduce the rate of poverty among the elderly and buoy them up from the bottom of the income scale. At the same time the effect of inflation on the income that the elderly have from private assets that they put aside during their working years has been devastating. They have lost enormously in terms of purchasing power and in terms of the value of the underlying assets. Thus inflation has tended to push the elderly down the income scale, leaving them concentrated just above the poverty line, where they are extremely vulnerable to cutbacks in entitlement programs.

Now last year there were such cuts. Medicare, for example, was reduced by $1½ billion, and these cuts directly translated into increased cost to beneficiaries. Other programs too were cut, and now these same programs are slated for additional cuts—about $7 billion worth in the administration's fiscal year 1983 budget.

Others say that the CPI has tended to overcompensate the elderly, giving them more than was necessary to maintain the purchasing power of their benefits and enable them to make ends meet. This is simply not the case.

The best study that has been done of the effect of automatic CPI increases over the period 1976–80 indicates that in some years there was some slight overcompensation, but that was offset by some undercompensation in other years. The net effect, then, was to leave the purchasing power of benefits relatively stable over the period 1976–80, given what it is the elderly spend their money on. As you know that tends to be necessaries: food at home, fuel and utilities, and medical care.

Those who think that the elderly can afford cost-of-living adjustment reductions ought to take a look at the statistics. They are quite dramatic. We now have 26 percent of all elderly-headed households with income of $5,000 or less. That compares to 9 percent of non-elderly-headed households. We have got 56 percent of elderly-headed households with incomes of $10,000 or less, as compared to only 20 percent of households headed by a younger person.

The poverty rate of the elderly has risen from the low point of 13.9 percent at the end of 1978 to 15.7 percent at the end of 1980, and that happened despite full cost-of-living adjustments in the entitlement programs in those years. The poverty rate is rising.

The near-poverty rate shows that 25 percent of the elderly are within 125 percent of the poverty category. These people are very vulnerable to cost-of-living reductions or other basic benefit cutbacks in the entitlement programs.

The two most prominent COLA cut proposals to surface in Congress are those advanced by Senators Domenici and Hollings; basically, they are identical. They call for no COLA this year, followed by CPI-minus-three in subsequent years.

We have had some projections developed that analyze the effect of what would happen to the elderly if these proposals went through. Let me give you some indication:

In 1981 the average benefit for a retired worker was about $385 a month; that's roughly $4,600 a year, and that is only $260 more than the poverty line in 1981—the poverty line was roughly $4400.

Under the Domenici and Hollings COLA proposals, a retiree would lose a full month's benefit in the first year; they would lose $384. Over the period 1982 through 1985 they would lose about $2,600 in income.

We have also looked at these proposals from the point of view of single women, age 72 and older. This group has an average income of roughly $3,100. That's below the poverty level, even now. Their social security income is, on average, $2,600. As you can see single aged women depend on social security for approximately 84 percent of their income.

If the Domenici and Hollings proposals were put into place this year, we have figured out that, rather than having 26 percent of this subgroup of the elderly in the poverty category by the year 1990, we would instead have nearly 40 percent of them in poverty. Look at it another way, the net effect of the Hollings/Domenici COLA proposals would be to push about 650,000 single women, age 72 and older, into the poverty category by 1990. Obviously, these kinds of proposals are simply unacceptable to us. There is just no way we could possibly go along with them.

Nevertheless, we do recognize that we face a very serious budget problem, and while our statement goes into great detail in terms of how we would deal with it, in summary I would simply say that we want it dealt with primarily from the revenue side of the budget. If you want to plan very large increases in defense, they are going to be paid for, somehow. You can't have huge increases for defense spending on the one hand, and enormous tax cuts on the other, and avoid the resulting deficits by putting the burden of curing those deficits on those least able to cope.

That concludes my statement, Mr. Chairman. I appreciate having had this opportunity to present it.

The CHAIRMAN. Well, thank you very much, Mr. Hacking.

I have been advised by the majority leader that we cannot meet beyond noon today. I have some questions that I wanted to ask, because I appreciate the spirit of your remarks, and I think we are going to have to find some way to keep inflation down, which is Public Enemy No. 1 as far as retired persons are concerned, and also bring down interest rates.

I wonder if I might submit those questions in writing, if that would be satisfactory?

Mr. **Hacking**. Certainly, Senator.

The **Chairman**. Senator Long, do you have any questions?

Senator **Long**. No, no questions.

The **Chairman**. Senator Bradley?

[No response.]

The **Chairman**. Senator Grassley.

Senator **Grassley**. Yes.

Are you adamant about any change in the CPI use for COLAs?

Mr. **Hacking**. Senator, we have long advocated that the Bureau of Labor Statistics be required to create a CPI that is an accurate reflection of what it is that older people buy. We think that if that were done there might be, at least in the short term, some significant savings to the entitlement programs. By using the CPI we have right now, which is not an accurate reflection of what it is older people buy, you may get some overstatement and therefore overcompensation just because what is happening in terms of housing costs and mortgage interest rates may not be offset by what is happening in terms of medical care costs, food costs, and fuel costs.

So we think that an accurate index that reflects what it is that the elderly buy should be put into place and implemented and used to adjust benefits in the entitlement programs. It might very well result in some significant savings.

Senator **Grassley**. As responsible as your position is, and it is responsible, it kind of puts off, though, maybe 2 or so years before any adjustment would be made in the portion of the budget that deals with what we call entitlements, and COLAs are a large part of that category—42 percent of the budget, I think.

Is there anything you would accept as an interim solution until we have the more accurate CPI?

Mr. **Hacking**. Well, Senator, we have been pressing this proposal since 1974. Had it been done then, we might be in better shape today.

We have made proposals on how you could reduce the rate of growth in expenditures in medicare and medicaid, and they are included in our statement. I do urge you to look at that, because, after all, those programs too are indexed, not quite in the same way that social security is but they are indexed.

The **Chairman**. Thank you very much, Mr. Hacking. We appreciate your past cooperation with our committee, and we look forward to looking with the staff and with all Senators.

Mr. **Hacking**. Thank you.

[The prepared statement follows:]

STATEMENT OF THE NATIONAL RETIRED TEACHERS ASSOCIATION AND THE AMERICAN ASSOCIATION OF RETIRED PERSONS

I. Overview of the Economy and the Budget

The deficits projected in the near term are resulting from the current intense recession, last year's huge and ill-targeted tax cuts and the large increases planned for defense spending. Reducing the deficit and making progress toward a balanced budget is critical to the economy for several reasons.

First, large and continuing deficits are viewed by both the public and by business as inflationary. This has created an environment that is not only likely to stimulate the wage/price spiral but also dampen incentives to save and invest on the part of individuals and business. The passage of last year's Economic Recovery Tax Act has not brought about any significant dampening of the public's expectations for continued inflation and has not generated the savings and investment necessary to promote recovery and long-term economic expansion.

Second, given the Federal Reserve's tight money policy (which unfortunately has been the only effective anti-inflation program in town), large deficits will lead to soaring interest rates, making it extremely difficult for the economy to recover from the current recession. At best the result will be either stagflation or a weak recovery followed by another recession.

Lenders are demanding high interest rates out of fear that inflation will remain elevated and resurge with any recovery, no matter how modest. Uncertainty has gripped the financial markets creating havoc and damaging the long-term investment which the economy needs. While the current recession may be bottoming out, the high unemployment and business disorder give rise to fears that the recession could deepen even further during the coming months. At present, there are simply no reliable signs that a recovery is under way. The high interest rates and tight money conditions, which precipitated the present recession, will remain with us until the deficit is brought down.

With respect to defense spending, we know of no instance of deficit financing of defense expenditures that did not prove to be inflationary. National currencies in such circumstances tend sooner or later to be destroyed. The threat to the U. S. dollar that results from opting for deficit financing to accommodate large increased defense expenditures only tends to reinforce the public's and the financial market's pre-existing expectation that inflation will be renewed -- and perhaps with such a vengeance that it will climb to levels higher than any previously experienced.

The economic outlook is bleak. One of our most important industries, automobiles, is best described as "on the ropes", along with our major agricultural implement manufacturers. Housing construction is at a virtual standstill. The savings and loan industry which supports home construction, is in grave financial circumstances. Bankruptcy statistics of small and medium firms have been approaching depression levels. Unemployment, now close to 9 percent, is likely to go to 10 percent. Unemployment in many of our snowbelt industrial cities has been rising towards levels not seen since the Great Depression of the 1930s.

The leading indicators turned downward in January, pointing toward a continuing reduction in business activity. In fact, January marked the ninth consecutive month of decline for the index. The stock market has recently dropped to new lows and the term "depression" has reentered our economic vocabulary.

Administration spokesmen are still predicting an explosion in savings rates followed by a great flow of funds into new investment. We would be very happy to see this, but there are no advance indications of such financial developments. How can depressed economy, irrespective of the lowering of marginal tax rates, generate enough personal income to boost savings? Corporate profits and corporate cash flows have been tepid. Surveys of the plans of business for capital investment show that it is doubtful that capital outlays, after correction for inflation, will be any greater in 1982 than they were in 1981.

In August, the Administration declared that once all of their economic program was in place, public expectations of continuing inflation would diminish, interest rates would decline, and there would be a rush of investment and innovative enterprise. This has not happened and there is no good basis for believing that it will in the near future. Revising the Administration's FY 1983 Budget so that the deficits start coming down would do much to bolster public confidence in the economy in the coming months.

The recession has been virulent enough to bring about some reduction in interest rates, but they remain astonishingly high when compared to current inflation rates. We have had some temporary relief from inflation; at the end of December, 1981, the three month average for the CPI-U was only 5.3 percent. The tight money policies of the Federal Reserve Board have substantially contributed to lowering inflation rates along with an additional measure of relief from the relative stability of crude oil prices. The abundant grain crop in 1981 also contributed in important ways to slowing inflation rates.

We are most thankful that inflation rates have come down. Unfortunately, the public, and those with money to lend, simply do not see inflation remaining at low rates. Deficit projections that run as much as 50 percent higher than the Administration's projections, frighten potential lenders all the more. The dangers of depression or, more likely, the dangers of a recession lasting for months to come, are attributable to continuing high interest rates caused by massive deficits in the projected federal budgets.

The only way to dampen these fears is for either the Administration to submit a new budget to Congress with a believable program for bringing the budget into balance or for Congress to develop its own. Credibility must be restored to our economic programs. For some weeks now, the Administration has been working on the theme that deficits do not matter that much; they are an unavoidable part of the current economic landscape. Unfortunately, the American public firmly believes that federal budgetary deficits are a prime cause of inflation -- ironically, a view which the current Administration fostered.

Deficits do matter, not only because the public believes that they do -- and the Gnomes of Zurich believe that they do -- but because they tend to inflate the money supply and because they cause the government to dip into the national pool of savings.

II. The Elderly's Eroding Position in the Economy

The nation faces a federal budget crisis of unprecedented proportions. Annual deficits far in excess of $100 billion are being projected for each of the next three years, pushing reasonable prospects for a balanced budget out of the foreseeable future. These looming deficits are bad for the economy and, furthermore, directly threaten the already deteriorating economic position of the elderly. Our Associations are pleased that Congress is moving to revise the President's FY 83 budget. A budget impasse is something we must avoid. The consequences for the economy at large and for the elderly in particular would be disastrous.

This Committee, with its jurisdiction over tax policy and the basic entitlement programs serving the elderly, bears a heavy responsibility for pursuing a deficit reduction strategy that, for the benefit of all Americans, will begin to move the budget into balance. This strategy, however must be pursued in a manner that recognizes that a decade of inflation has forced the elderly into an extremely vulnerable economic position -- a position in which they find themselves heavily dependent on government entitlement programs for the bulk of their income support. This Committee must realize that the immediate consequences of large-scale cutbacks in programs, such as social security, Medicare and Medicaid, will be even greater increases in the elderly poverty rate than we are already experiencing and a more rapid deterioration in their subsistence-level standards of living.

In the past few weeks, we have witnessed a veritable flood of budget proposals and alternatives. Regardless of the specifics of each, the essence of their message is readily apparent: large, escalating deficits are not acceptable. What is acceptable is, of course, more difficult to determine.

Realistically, no Member of Congress nor any constituency group is likely to be entirely happy with what is devised. We recognize that the elderly are not likely to be completely spared some measure of pain--even though they have suffered much more than their fair share already. What we are seeking--and what we hope the members of this Committee are seeking--is a fair and balanced package which makes good economic sense by making a maximum effort to raise revenue and cut back expenditures in areas and in ways that do not do damage to program benefits of vital importance to lower income persons--especially the elderly. Cuts--particularly those in basic entitlement programs--would drastically undermine the economic situation of the elderly and leave them even more vulnerable than they already are to the escalating costs of health care and to inflation in general. At this time, it is safe to say, none of the alternative budget packages currently "on the table" meet the test of fairness and economic soundness that we have in mind.

In 1980, Data Resources, Inc. (DRI) completed a study for our Associations on "Inflation and the Elderly." That study found that the average elderly incomes (in aggregate terms) managed to slightly exceed the general rate of inflation from the late 1960's through the late 1970's. Consequently, by 1978, the average income of those over age 65 was about 55 percent of the average incomes of the non-elderly. This progress resulted from the deliberate expansion of government programs, especially social security, in recognition of the extremely high (25-30%) elderly poverty rates prevailing at that time. Also, the creation of Medicare, Medicaid and SSI helped a great deal to improve the elderly's economic status.

Despite progress made in raising the elderly's average income levels and reducing poverty among them, there is mounting evidence that inflation has begun to wipe away that progress. Elderly poverty rates, on a steady decline through 1978, increased from 13.9 percent in 1978 to 15.1 percent in 1979 and again in 1980 to 15.7% -- the largest increase in the elderly poverty rate since the Census Bureau began collecting such data and the highest poverty rate of any adult age group. We believe that the fixed nature of the elderly's income components as well as their inflexible consumption patterns -- particularly for food, fuel and medical care -- are largely responsible for the substantial increase in the elderly poverty rate.

Moreover, despite the limited growth in the elderly's income during the period 1968-1978, the continuing escalation of the elderly's poverty rate and other statistics demonstrate the disadvantaged position of the elderly relative to the rest of the population. For example, in 1980, while only 9 percent of non-elderly households had annual incomes below $5,000, 26 percent of elderly households had annual incomes below $5,000. Similarly, only 20 percent of non-elderly head-of-households had annual incomes under $10,000, while 56 percent of the elderly head-of-households had incomes in that category. Even adding to their income the cash-value of the in-kind benefits the elderly receive does not change the reality that the elderly, as a group, generally subsist on low and in many cases wholly inadequate incomes. In 1980, over half of all individuals age 65 and above -- more than 13 million people -- had an average annual income of less than $5,000.

III. Drastic COLA Reductions Unacceptable As Budget Alternatives

Faced with rising deficits, Congress has been casting about for a relatively simple and quick means of reining in what now makes up a large portion of the budget. Cost-of-living increases in al federal entitlement programs, thus, represent a convenient target. What is ignored by those who have espoused drastic reductions in cost-of-living increases is the devastating impact such cuts would have on the elderly population -- especially for subgroups among them -- namely the oldest among them and, in particular, older women.

For millions of older persons, cost-of-living increases provided by social security and other retirement programs are the only income that stands between them and poverty. Indexing mechanisms are the only inflation protection they have. A decade of high inflation has rapidly eroded the value of their non-indexed sources of income, such as, private pensions savings and other dollar-denominated assets, which represent about one-third of their total income. This situation has left the elderly -- through no fault of their own -- heavily dependent on federal entitlement programs.

A number of Congressional budget alternatives propose to reduce cost-of-living adjustments. Perhaps the two most prominent are those offered by Senators Domenici and Hollings.

Their proposals would slash cost-of-living adjustments (COLAS) in social security as well as the other income security programs such as SSI, civil service, military and railroad retirement and veterans' pension program. While there are some differences between these two proposals they both would: entirely eliminate the July, 1982 cost-of-living adjustments for these income security programs and, in succeeding years, provide a COLA calculated to be the Consumer Price Index (CPI) minus 3 percent. (Senator Hollings also proposes to delay the FY 83 and subsequent COLA's by shifting them from July to October. Currently, beneficiaries receive the full CPI based COLA each July.) Based on CBO economic assumptions, this proposal is estimated to save $3.6 billion in FY 1982 and about $84-87 billion in FY 1983 through FY 1985, with over 80% of the savings from social security.

Lost in all the talk of macro-dollars and fiscal years is the likely impact of such a cut on the elderly. To explain the impact of the proposed COLA cuts in individual terms, social security beneficiaries -- by far the largest group to be affected -- can serve as valuable examples.

According to the Social Security Administration (SSA), the average social security benefit for a retired worker is $4,620 per year ($385 per month) -- only $260 above the official 1981 poverty level for singles of $4,360.

For this average social security beneficiary, the Domenici/Hollings proposals would cut benefits in the first year by $384 (almost one month's benefit) and by $2,592 over the 1982-85 period.

Similarly, according to SSA, the average social security benefit for a retired couple is $570 per month ($6,840 per year). For a retired couple, the proposals would cut benefits in the first year by $564 and by $3,792 over the 1982-85 period.

As of 1980, according to Current Population Survey statistics there were approximately 1.3 million single women 72 or older who had total incomes of under $4000 per year, an income level very close to the poverty level. The average social security benefit received by these women was $2,619 - approximately $220 a month. Again for this same group, total average income was approximately $3,103 implying that the "average widow", 72 or older, relies on social security for roughly 84 percent of all of her income.

Even more startling, on the basis of preliminary simulations prepared by DRI (using AARP's econometric model of elderly incomes), by 1990, implementation of the Domenici/Hollings proposal would result in 39 percent of single women, age 72 or older, having incomes under $4,000 in today's dollars (this is approximately the poverty threshold for single persons). Without implementation of this proposal, "only" 26 percent of women age 72+ would be in poverty. The Hollings/Domenici proposal would add an additional 656,000 elderly women to the poverty rolls expected for 1990. These are preliminary estimates and we will provide the Committee with additional data reflecting the impact of COLA cuts on other elderly subgroups.

It is often argued that the CPI has significantly overcompensated the elderly. These assertions are wrong. The best studies show that the elderly concentrate their expenditures on necessities -- food, fuel and utilities and medical care -- the prices of which have risen rapidly. Therefore, while there has been slight overcompensation in some years, there has been undercompensation in other years.

Many have argued that the elderly have additional outside income, and can afford a cut, i.e. no adjustment for increases in the cost-of-living. Given the nature of social security -- a social insurance program and not a means-tested welfare program -- some individuals in social security could get by. But, this is a minority. Again, one must consider the facts:

- The elderly are an extremely vulnerable, lower income group, especially compared to the non-elderly -- in 1980, 56% of persons age 65+ had income below $10,000 and 26% had incomes below $5,000.

- Poverty rates among the elderly are the highest for any adult age group and are rapidly rising. For two years in a row, the aged poverty rate escalated dramatically from 13.9% in 1978 to 15.1% in 1979 and up again in 1980 to 15.7%. Reducing cost-of-living protection would worsen this trend.

- So many of the elderly have incomes just above the poverty line, that a crop of $20 to $24 a week in their average income in 1980 would have caused the aged poverty rate to soar to over 25%.

For many elderly, cost-of-living increases are the only income keeping them out of poverty. (It cannot be forgotten that SSI, an income security program for the poor elderly, would also be subject to this cut.)

•In addition, the elderly -- particularly the most vulnerable among them (the oldest and widows) -- have just been hit by over $4 billion in cuts in federal programs serving their health, nutrition, and basic income needs as a result of last year's budget cuts. And cuts in many of these programs are on the agenda again this year. Drastic cuts in COLA's would be a major step backwards by taking the "security" out of the income security programs on which the elderly depend.

IV. The Need to Raise Revenues

To protect the economy and the well-being of the elderly, the budget deficit must be reduced in a manner that is consistent with the goal of achieving economic recovery and will reduce the mounting pressure to cut entitlements. To do this, the Associations believe that revenues must be increased. As a first step, we feel that Congress should take a careful look at the tax code to remove tax expenditures that may no longer be useful. Also, new taxes may have to be implemented and existing ones raised. Finally, if these measures do not raise a sufficient amount of revenue, portions of the Economic Recovery Tax Act of 1981 should be scaled back or repealed.

The following provisions do not cover all revenue-raising possibilities. However, the Associations offer them as an indication that significant revenue can be raised without jeopardizing economic recovery. In fact, we believe that measures such as these are absolutely essential if economic recovery is to occur at all.

1. Repeal tax expenditures if their costs outweigh their economic usefulness

Changing economic circumstances make it imperative for Congress to periodically review tax expenditures (i.e., tax provisions that cause revenue loss) to determine their expense and their value. If Congress can control the growth of tax expenditures, it will take a major step toward stabilizing the federal budget.

a) According to the Congressional Budget Office[1] a repeal of certain oil and gas industry tax expenditures could raise $10 billion in FY 1984. $1.6 billion can be gained by repeal of the percentage depletion allowance, which is a write-off of 18 percent (in 1982) of the gross income (up to a limit) from select oil and gas wells. This method often allows the well owner to recover much more than the cost of extraction. Additionally, $8.4 billion can be raised by repeal of the expensing provision for intangible oil and gas drilling costs. This would allow certain oil and gas drilling costs to be written off in the year they occurred rather than adopting the general approach of depreciating these costs over a period of years. Given the major restructuring of the corporate income tax that was a part of the Economic Recovery Tax Act of 1981 and the rapid increase in energy prices, these incentives to produce may no longer be necessary.

b) The deductibility of consumer interest payments will cost $7.8 billion in FY 1984. Because of the increasing need to encourage people to save and invest, this tax expenditure may be counterproductive. Also, the tax break is available only to persons who itemize their deductions in computing their income tax liability.

---

[1] Unless otherwise stated, the revenue figures can be obtained in the Congressional Budget Offices' Report to the Senate and House Committees on the Budget, Part III: Reducing the Federal Deficit: Strategies and Options. February 1982.

2. Portions of the Economic Recovery Tax Act of 1981 can be modified without harming the Act's intent

   a) The corporate "leasing" provisions will cost about $4 billion in FY 1983. If leasing is felt to be desirable, Congress should at least structure the law to limit its applicability.

   b) Repeal of the Windfall Profits Tax reductions would save $1.7 billion in FY 1983 and $2.2 billion in FY 1984. The Windfall Profits Tax provisions include an exemption for some royalty owners, reduced rates for certain oil of independent producers, a reduced rate on newly discovered oil and an exemption for oil rights owned by qualified charities that care for children (the last item has a very small revenue loss figure). Source: Joint Committee on Taxation Summary of H.R. 4242.

3. New or increased taxes which are consistent with an economic recovery program should be implemented

   a) A windfall profits tax on deregulated natural gas could raise up to $12 billion in FY 1984 if decontrol were moved ahead to January 1, 1983.

   b) Doubling the liquor tax will raise $3.5 billion in FY 1984.

   c) Doubling the excise tax on beer and wine will raise $1.3 billion in FY 1984.

   d) Doubling the cigarette tax will raise $1.8 billion in FY 1984.

The taxes discussed in proposals (b) - (d) were last raised in 1951.

4. The indexing of the income tax brackets, the zero bracket amount and the personal exemption that is due to begin in 1985 should be repealed or delayed until economic conditions improve

The Associations realize that bracket creep due to inflation has increased the tax burdens of workers. However, the existence of the indexing feature in 1985 builds revenue losses into the future on top of massive deficits. The future deficit projections are creating havoc with the credit markets. We feel that a willingness to resolve the long-term deficit problem should be displayed prior to the introduction of an indexing system into the code.

5. If the deficit reduction measures listed above (along with others Congress may choose) are insufficient, the personal tax rate reductions that are included in the Economic Recovery Tax Act should be postponed or scaled back or even repealed

While we believe that this should be a last resort for Congress, a postponement of the rate cuts may be needed to improve the deficit situation. A postponement of the July 1983 ten percent cut will save $27 billion in FY 1984.

In total, these measures (excluding #4) will reduce the federal deficit by about $70 billion in FY 1984. Depending on when they are implemented, they would also have a positive impact on the FY 1983 deficit.

V. Health Care Cost Inflation and Medicare/Medicaid

A. Medicare

The elderly are well aware of the escalating increases in health care costs and the pressure such increases have generated to slash the Medicare program. Last year the Congress chopped $1.5 billion out of Medicare, resulting in a 27 percent increase in the elderly's out-of-pocket costs for Medicare deductibles and co-payments which in turn automatically caused substantial increases in the elderly's out-of-pocket costs for supplementary Medicare insurance.

The Administration's Medicare proposals fail to address the major source of escalation in Medicare expenditures -- explosive hospital cost inflation. Instead, their proposals merely shift the cost directly or indirectly to program recipients and private paying patients.

The Associations believe that any changes in the Medicare program must be evaluated by criteria that: (1) address the source of pressure on the Medicare program (i.e., spiralling hospital costs); (2) contribute to the development of less expensive, appropriate care; (3) avoid cost shifting to program beneficiaries and (4) encourage the elderly to be independent. Thus, with these four criteria in mind, the Associations offer the following comments on the Administration's major proposals to cut Medicare.

- Forcing employers to pay health insurance coverage for older workers (savings, $306 million, 12.2 percent of the total projected Medicare savings in FY'83). Making the employers' health insurance plan the primary source of coverage for older workers health care claims will force up the cost of employing older workers because the employer's health insurance carrier, faced with primary responsibility for covering health claims heretofore covered by Medicare, will insist on being compensated for the additional risk of exposure. Moreover, despite the Age Discrimination in Employment Act's provision allowing employers to provide reduced health insurance coverage for older workers (so long as the employer spends the same amount on premiums for older workers as younger workers), this proposal forces employers to provide health insurance coverage for older workers as equal to the coverage provided younger ones on the penalty of not being permitted to claim the full cost of health insurance premiums as a tax deduction.

- Reduce waste and service utilization (savings, $372 million, 14.9 percent of the total projected Medicare savings in FY'83).

The thrust of this initiative is to give Medicare contractors greater responsibility for the identification and reduction of waste in the provision and use of health care services. Yet, despite nearly 9 percent inflation, the Administration refuses to provide additional funds to pay contractors for this additional responsibility. Moreover, this proposal appears to conflict with another of the Administration's proposals -- that is, to eliminate federal funding for Professionals Standards Review Organizations (PSROs) in July of this year. PSROs' responsibilities include the Administration's objective of reducing unnecessary utilization. Therefore, it is inconsistent for the Administration to propose the demise of PSROs while at the same time stress the need for increased utilization review to produce substantial savings.

Our Associations are very skeptical about this proposal. Though details are not yet available, it is difficult to see how the large savings claimed are possible merely from "eliminating waste and over-utilization." Forced to achieve such savings, Medicare contractors are likely to disallow heretofore covered expenditures or to make the reimbursement process even more cumbersome, difficult and confusing for beneficiaries than it already is.

- 2 percent reduction in reimbursement to hospitals for the care of Medicare patients (savings, $653 million, 26 percent of the proposed Medicare savings in FY'83).

A large reduction in program expenditures under this proposal are likely to be illusory because hospitals can easily make up the loss by ordering more ancillary services. Moreover, since the federal reimbursement rate is already 16-20 percent below what hospitals charge their private pay patients, such Medicare specific cuts will likely shift more cost to private patients.

The Associations believe that this proposal contributes nothing to solving the real crisis facing the Medicare program, namely; restraining the exorbitant increases in hospital costs. Furthermore, it is likely that any savings realized under this proposal would be shifted to private paying patients.

- Indexing the Medicare Part B deductible to the Consumer Price Index (savings, $65 million in FY'83); institute co-payment for home health services (savings, $35 million in FY'83); establish Medicare eligibility at the beginning of the first full month after attaining age 65 (savings, $145 million in FY'83).

Taken together, these proposals represent 9.8 percent of the Administration's projected Medicare savings in FY'83. They seem to be predicated on the notion that the elderly should bear a greater portion of the health care costs under Medicare in order to increase cost-consciousness. The elderly are already, however, extremely cost-conscious -- paying about 43 percent of their total health care expenditures out-of-pocket. They simply cannot afford to absorb additional cost-sharing under Medicare.

The Administration cites certain findings of a recent General Accounting Office (GAO) report as justification for charging a co-payment for home health services under Medicare. The Administration's proposal to require beneficiary co-payment, however, is a misdirected solution to the problems in home health services identified by GAO. Furthermore, the introduction of a co-payment for home health services, contrary to the Administration's intended purpose, could result in greater Medicare cost because patients, in order to avoid increased out-of-pocket costs, would choose to remain either in the hospital or a skilled nursing facility.

Later this year, the Administration will propose measures to improve market forces in the health care industry and in the Medicare program. No costs or savings from these efforts are assumed until 1984, and as yet, no details have been specified. Since the program is likely to include, however, a voluntary Medicare voucher plan and a new Medicare co-payment, the Associations feel that a comment on this proposal is appropriate at this time.

The proposal, as we understand it, includes a voluntary voucher plan, a new Medicare co-payment of 10 percent of the daily cost of a hospital room, up to a maximum of $26 per day, for the 2nd through 60th day of hospitalization, and a catastrophic stop-loss provision that would indemnify Medicare beneficiaries for all covered hospital and physician costs above $2500 or $3000 per year. (The stop-loss protection does not include expenditures incurred for noncovered service, such as, outpatient prescriptions, eyeglasses, nursing home care, etc.)

To the extent that a voluntary Medicare voucher proposal contributes to reforming this nation's costly health care delivery system, the Associations welcome the dialogue such a proposal would create. At this point, however, we are skeptical about any plan that includes substantial new out-of-pocket costs for Medicare patient . The elderly are still absorbing the substantial increases in Parts A and B deductibles and coinsurance enacted last year. Moreover, the catastrophic stop-loss protection, while it would aid a small number -- perhaps 3% -- would be in exchange for a doubling of cost for the average hospital stay of a Medicare beneficiary.

Therefore, the Associations believe that employers' and the employees' health insurance tax preference should be conditional on their group health insurers' adhering to

Medicare established hospital reimbursement limits and offering a variety of health plans, including HMOs. This will create incentives to hold down skyrocketing hospital costs. By conditioning these tax expenditures in such ways, the powerful incentives to develop more comprehensive health insurance coverage will be reduced and pressure from employers and employees on carriers and providers will hasten the development of less expensive health care delivery systems.

On the supply side of tax expenditures, severe and immediate limitations should be placed on the tax exempt status of hospital bonds. (For hospitals able to demonstrate the need for new construction in a growth area, this subsidy could be retained or gradually phased out.) Approximately half of the funding for hospital capital projects comes from tax exempt bonds ($5.1 billion of these bonds were issued in 1981). The direct federal revenue loss from all outstanding hospital bonds in FY 1982 will be $700 million. Our Associations seriously question the efficacy of this subsidy which allocates resources on the basis of a hospital's financial standing rather than the need for such facilities. Moreover, the magnitude of this subsidy promises to substantially increase should local health planning and the certificate of need process be phased out as the Administration has proposed. In those areas of the country that are already overbedded, tax exempt hospital bonds further escalate Medicare and Medicaid reimbursement levels for empty unneeded beds. Every $1 saved by borrowing hospitals costs $1.33 in lost federal revenue.

The Associations recognize a responsibility to suggest alternatives to the Administration's Medicare budget proposal. In that spirit and in light of the current fiscal dilemma, we urge this committee to thoroughly examine the efficacy of tax expenditures in the health sector. Unlike Medicaid, which is a direct federal health subsidy benefiting the poor, health insurance tax expenditures are indirect federal health subsidies that, according to the Department of Treasury, primarily benefit the middle and upper income groups.

Between 1975 and 1979, Medicare expenditures grew at an annual rate of 17 percent per year. At the same time, health insurance related tax expenditures grew at an average annual rate of 19 percent per year. It is grossly inequitable to continue cutting direct federal health subsidies, like Medicare and Medicaid, while ignoring the fastest growing federal health subsidy -- health related tax expenditures. Furthermore, these tax expenditures have created powerful incentives for comprehensive, first-dollar health insurance coverage; this trend has promoted excessive increases in health care costs, including the costs of the Medicare and Medicaid programs.

The Associations have long urged the Congress to place federal limits on increases in hospital revenues per admission. Such an across-the-board approach would not single out Medicare or Medicaid beneficiaries for special restrictions. Time and again, experience has demonstrated that Medicare-Medicaid specific approaches to hospital cost containment merely lead to cost shifting and, thus, no reduction in the rate of increase in total hospital costs.

Unfortunately, Congress has rejected the imposition of uniform, across-the-board limitations on increasing hospital costs. Alternatively, the Associations recommend that Congress actively encourage the states to adopt mandatory hospital rate review programs. Such programs have been successful in the six states that have them because they reduce both public and private sector outlays for hospital care. As an incentive for states to institute rate review programs, the Federal Government might share a portion (perhaps one-third) of the savings in Medicare and Medicaid costs that are achieved through rate review programs in the States. Providing financial incentives for states to initiate effective hospital rate review programs could produce substantial savings to both government and private purchasers of hospital care services.

The Associations also would like to briefly comment on other budget proposals that, while not in the Medicare program directly, would clearly escalate Medicare outlays.

First, the proposed phase-out of federal support for local health planning in FY 1983 risks substantial increases in health care costs. In essence, the Administration is offering health care competition in lieu of regulatory "barriers" in the marketplace. While we believe that incentives can change the health care delivery system in constructive ways, we seriously doubt that "competition" alone can provide the strong constraining mechanisms required to control spiralling costs in the health care sector. Moreover, we question the wisdom of dismantling the only proven, locally based cost-containment program in place, before the efficacy of "competition" to control costs has been demonstrated. The Associations view health planning and the certificate of need process as a viable state and local decision-making process which has demonstrated success in the battle against rising health care costs.

In their haste to eliminate health planning and deregulate the health care marketplace, the Administration will create a void in which costs will skyrocket -- especially Medicare cost reimbursement for hospital capital expenditures.

The Associations urge the Congress to maintain a viable local health planning presence and capability that will help contain the increase in health care costs and thus, the cost escalation in Medicare in FY 1983 and beyond.

Finally, the Associations urge the Congress to provide elderly Medicare beneficiaries equal access to Health Maintenance Organizations (HMO) through changes in the way Medicare reimburses for services. This would result in real, long-term savings to the Medicare program. As individuals, the elderly for the most part cannot enroll in HMOs. Changing reimbursement from a cost plus to a prospective, prepayment basis for Medicare beneficiaries, with required open enrollment periods, would act as a powerful incentive for the development of the HMO option for all segments of the population. Clearly, retrospective, cost-based reimbursement is not financially attractive nor viable for all but the largest and richest HMOs. Without making these reimbursement changes, the elderly will, for the most part, continue to be denied access to HMOs and Medicare outlays will continue to escalate at unnecessarily high rates.

B. Medicaid

Approximately 3.6 million low-income aged individuals -- 1 out of every 7 older Americans -- will be Medicaid beneficiaries in 1983. As the primary public health care program addressing the long-term care needs of the elderly, Medicaid is an essential program for this vulnerable segment of our population.

The Medicaid provisions in the Omnibus Budget Reconciliation Act of 1981 cut Medicaid expenditures by approximately $900 million in FY 1982; they will cut another $900 million in federal Medicaid expenditures in FY 1983.

For FY 1983, the Administration is requesting new Medicaid cuts totalling $2.0 billion. The cuts proposed reduce federal program costs by shifting them to the states, program beneficiaries and their relatives. Yet, most states have already reported funding problems and beneficiaries, by definition, are low-income individuals -- those least able to afford increasing out-of-pocket expenditures for health care.

Three major Administration proposed cuts are described below. They represent over 50 percent of the proposed reduction in federal Medicaid spending for FY 1983. Like the Medicare proposals, unfortunately, the Medicaid proposals do not address the underlying cause of escalating Medicaid expenditures -- soaring inflation in the health care sector.

1. Reduce the federal match by 3% for optional services and beneficiaries (savings: $600 million; 30% of the

proposed Medicaid cuts in FY 1983).

This proposal reduces federal Medicaid matching payments to the states for optional services to the categorically eligible and for all services provided to the medically needy by 3 percent. The effect of this cut is to shift costs from the federal government to the states.

The majority of states are already facing, however, severe financial strains in their Medicaid programs; hence, many states are cutting back on optional services and restricting eligibility for Medicaid. This proposed reduction -- on top of the 4% reduction in the federal share of Medicaid already scheduled for FY 1983 -- will result in states making additional cuts in optional services and further restricting eligibility.

For the elderly who depend on Medicaid for long-term care, this cut further threatens the availability of qualified skilled nursing facility (SNF) and intermediate care facility (ICF) services. ICF care would be particularly hard hit; as an optional service, it would be subject to a 3% reduction in the federal match for every beneficiary.

Furthermore, optional services include prescription drugs, dental care, eyeglasses, and hearing aids. These are critical services to elderly beneficiaries struggling to maintain functional independence. The introduction of or increase in co-payments for these services...or their total elimination...will reduce the elderly's access to needed care.

2. Allow states to recover long-term care (LTC) costs from beneficiaries' adult children and estates (savings: $283 million; 14 percent of the proposed Medicaid cuts in FY 1983).

This proposal would allow states to require adult children of institutionalized Medicaid beneficiaries to contribute to the cost of their parent's care. Inherent in such a policy decision, however, are difficult problems of definition, equity and perhaps, due process of law. For example, could children living in one state be forced to contribute to nursing home care for their parents living in another state? Should children be required to support their parents, even in instances where the parents provided little or no support to their children? How would adult children be defined (i.e., biologically related, step-children)? If the children refused to contribute, would the parent be denied care?

Moreover, elderly individuals needing nursing home care are likely to be over 75 years old. Their adult children may be nearing retirement or already retired themselves -- living on fixed incomes with their own health care needs increasing. If the adult children are younger and have families of their own, the choice may become paying for their parents' nursing home care or sending their own children to college.

3. Establish co-payments for Medicaid mandatory services (savings: $329 million; 16 percent of the proposed Medicaid cuts in FY 1983).

The Administration is proposing to require a $1.00 and $1.50 per visit co-payment from the categorically and medically needy, respectively, for physician, clinic, and hospital outpatient services; $1.00 and $2.00 per day co-payment for inpatient hospital care would be required of the categorically and medically needy, respectively, as well.

As with the Medicare proposals to increase beneficiary cost-sharing, this Medicaid proposal is based on the notion that beneficiaries should be more cost-conscious about health care services; if co-payments are instituted, beneficiaries will "think twice" before utilizing these services.

While the stated purpose is to discourage the use of unnecessary care, cost-sharing could cause beneficiaries to postpone obtaining needed care until the illness or injury reaches crisis proportions. This could result in higher treatment costs over the long term.

In addition, these co-payments -- added to existing and expected co-payments for optional services (if those services continue to be provided at all) -- would create a hardship for Medicaid beneficiaries who already are, by definition, low-income people.

Beyond proposals with large dollar savings, however, the proposed Medicaid cuts reveal a serious lack of empathy for some of the most vulnerable of this nation's citizens. The Administration's proposal to reduce states' acceptable error level to zero over a four year period is a case in point. While the Associations recognize that errors must be held to a minimum, human experience portends that it is not realistic to expect a zero error rate in a $32 billion program as complex as Medicaid. The effect of this policy phase-in will be to deny Medicaid services to those who are unable to document every detail of their Medicaid application. States faced with a prospective disallowance for services already rendered, will turn down otherwise qualified applicants because the information on their applications is either marginal or of a preliminary nature. Instead of offering help and hope, Medicaid will become a harsh and arbitrary, inflexible bureaucratic quagmire.

Furthermore, the Administration's intention to eliminate special matching rates for nursing home inspections is a serious threat to the most vulnerable aged. The federal government's encouragement of nursing home inspection programs is based on years of documented nursing home abuses. The Administration's retreat in this regard is particularly unfortunate, especially in light of the severe cuts in nursing home reimbursements described herein and HCFA's continuing efforts to "deregulate" the nursing home industry.

VI. Social Security

In FY 1982, more than 95 percent of the nation's citizens 65 or older, and their dependents, will be eligible for social security benefits. About 36 million persons receive OASDI benefits, and more than 115 million workers currently contribute to the system.

Federal outlays for OASDI totalled $139.6 billion in 1981, are estimated to total $158.1 billion in 1982, and (based on CBO's baseline projections) will total $173.6 billion in 1983.

There is a general consensus that the social security system is facing short-and long-term financing problems due, in large part, to demographic trends and unfavorable economic conditions. While action is needed to assure solvency of the social security trust funds in the future, the budget cutting process is not an appropriate forum in which to address this problem.

Last year, the Congress and the American public overwhelmingly rejected the Administration's proposal to make massive cuts in social security. However, this essential entitlement program did not go unscathed during the budget process. The combination of the 1981 Omnibus Budget Reconciliation Act and the Social Security Amendments of 1981 (H.R. 4331) resulted in social security cuts including: elimination of the minimum benefit for new beneficiaries; phase out of post secondary student's benefits; phase out of mothers' and fathers' benefits when youngest child is aged 16 and over; elimination of lump-sum death benefit when there is no surviving spouse or surviving entitled child; and retaining the retirement test exempt age at 72 through 1982.

The combined effect of all enacted 1981 social security legislation resulted in spending cuts totalling $2.127 billion in calendar year (CY) 1982 and $2.854 billion in CY 1983.

Recognizing both the system's financing problems and the political sensitivity of the issue, the President created a fifteen-member National Commission on Social Security Reform. This commission, given the task of developing a bipartisan solution to social security's financing problems, is not to report back until the end of 1982. Therefore, with the Administration waiting for the results of the commission's work, it did not include any social security (OASDI) proposals in its FY 1983 budget.

As we have testified to this Committee previously, social security faces a serious short-term deficit which is expected to persist throughout the 1980s. This situation is the result of adverse economic conditions. Congress has little choice but to develop a remedy for the short-term deficit, since exhaustion of the reserves of Old Age and Survivors' Insurance (OASI) Fund as well as the Hospital Insurance (HI) fund is projected to occur soon. Interfund borrowing, reallocation of the payroll tax rates or any other type of pooling of trust fund reserves cannot be relied upon to carry the system safely through this decade. Indeed, recent projections indicate that interfund borrowing which was only recently authorized by Congress will prove inadequate as early as mid to late 1983.

Rather than drastically reducing benefits through cuts in cost-of-living adjustments or other precipitous, hasty benefit curtailments, Congress should cushion the system by using limited and temporary amounts of general revenue -- just enough general revenue to permit it to meet its short-term benefit obligations. Our Associations recognize the reluctance to authorize the use of general revenue funds for social security. However, if the Congress continues to face one after another short term "crisis" in social security's financing -- again, largely due to worse than expected performance by the economy -- the more serious long term reform of social security will take a back seat. And, for each year that this task is delayed its resolution becomes more difficult. Once the social security system is stabilized, as is expected after 1990, any use of general revenues should automatically cease. Action to implement this plan however, should be accompanied by initial steps toward resolving social security's long-term deficit. Our Associations testified before this committee last July outlining our proposals in detail for long term reform of social security and look forward to working with the Committee in the coming months in this regard.

VII. Conclusion

The nation faces a federal budget crisis of unprecedented proportions. This Committee, with its jurisdiction over tax policy and the basic entitlement programs serving the elderly, bears a heavy responsibility for pursuing a deficit reduction strategy that, for the benefit of all Americans, will begin to move the budget into balance. This strategy, however, must be pursued in a manner that recognizes that a decade of inflation has forced the elderly into a position in which they find themselves, through no fault of their own, heavily dependent on government entitlement programs for the bulk of their income support. The immediate consequences of large-scale cutbacks in programs like social security, Medicare and Medicaid will be even greater increases in the elderly poverty rate than we are already experiencing and a more rapid deterioration in their subsistence-level standards of living.

What we are seeking is a fair and balanced package which makes good economic sense by making a maximum effort to raise revenue and cut back expenditures in ways that do not do damage to program benefits of vital importance to lower income persons--especially the elderly.

The CHAIRMAN. We now have a panel consisting of the Honorable Richard A. Snelling, Governor, State of Vermont, and the Honorable Scott Matheson, Governor, State of Utah.

Governor?

Governor SNELLING. Mr. Chairman, Governor Matheson will be very briefly delayed, but we have a division of labor, anyway. So, whenever you are ready, perhaps I might begin.

The CHAIRMAN. Fine.

Again, we have a procedural problem in that we can't meet beyond noon. So we have been asking witnesses if they could summarize statements that we might have some time for questions, and if Governor Matheson is late, certainly his statement will be included in the record. He is an excellent witness and has been before this committee before.

So you may proceed in any way you wish, Governor.

STATEMENT OF HON. RICHARD A. SNELLING, GOVERNOR, STATE OF VERMONT

Governor SNELLING. Thank you very much, Mr. Chairman.

Senators, we are delighted to be asked to testify, and I will summarize to the nth degree.

The Governors have a consensus, which all by itself I would hope would be significant to the Congress, given the difficulties that you might expect in reaching a consensus on some of these subjects.

Furthermore, the Governors have been working very closely with legislators, county officials, mayors, and we think there is an emerging and ever-strengthening consensus among us on an intergovernmental basis as well.

Two fundamental propositions which need to be stated can be stated briefly: We do not believe that the fiscal year 1983 budget cuts which have been proposed could be accepted by State and local governments paired with any kind of a promise on our part that we would in fact deliver the services which the Congress and the people are expecting us to deliver.

Furthermore, those budget cuts in many ways would erode the very capacity which we and many Members of the Congress, hope will be utilized in the future to provide Government which proceeds at a more appropriate level of governance.

No. 2, the Governors feel very strongly, by a very, very large majority, that federalism is an idea whose time has come, that it ought not to be put on the back burner, it ought not to be delayed, and that it deals very fundamentally with your long-term problems. The question is, how to get more appropriate actions which meet the goals which you have set out and in some cases that the Supreme Court has set out in an era which is probably going to have to deal with financial restraint for a very long time?

We believe that the proposal that has been offered by the President, and the counterproposal which has been offered by the Governors, both represent very important initiatives in this area. We hope that before another 30 days has passed that we will be able to bring to you and to support a proposition which will have the leadership of the President and the support of almost all of the non-Federal governmental units. It will put government where it can perform best, with a kind of flexibility necessary to make a lesser number of dollars perform better.

I would like to have the opportunity of answering any questions that the Senators may have about either of these, of course huge, propositions.

The **Chairman**. Well, I might say first of all that, as I view the new federalism, including the trust fund and AFDC and medicaid, all those matters are properly within the jurisdiction of this committee. I understand there may be another committee trying to review those matters, so we may have our own jurisdictional question to resolve. But I don't see any real problem.

We appreciate the fact that there have been Governors, Democrat and Republican Governors alike, trying to reach some consensus and help the administration develop a plan that you believe that not only the present Governors but future Governors in both parties can live with. I think that in itself is encouraging. I think it is an exciting concept that has a lot of work yet to be done. Some of the programs probably can't be transferred; with some, maybe we can compromise.

I want to yield first to Senator Long, if he has questions.

Senator **Long**. I think that's a fine statement, Governor, and I find nothing to quarrel with about it.

The **Chairman**. Senator Bradley?

Senator **Bradley**. Governor Snelling, I am interested in the idea that has been floated by a number of Governors, you among them, I think. It says, if we are going to get into this new federalism debate that maybe we ought to separate programs which provide assistance to individuals, such as medicaid and food stamps, from programs that affect institutions generally, such as law enforcement and transportation. If we are going to reallocate responsibility, are you in the school that thinks that the programs of assistance to individuals ought to be handled almost entirely by the Federal Government, with education and the criminal justice programs going back to the States?

Governor **Snelling**. That is not at all incompatible with the proposal that the President has made. The traditional position of NGA—which is not a few Governors; the positions are always adopted by at least a two-thirds majority and our present position has the support of perhaps 80 percent of the Governors—historically has been and is that it really would be best to sort out, by letting income maintenance programs flow to the Federal level and a very large number of other programs—some of those that you mentioned: law enforcement, education, local transportation and many others—become a prime responsibility of the States.

But the principle here is that there be a sorting out. The President's response is in harmony with that principle, but the Governors do not agree that they should be asked to take responsibility for AFDC and food stamps in exchange for a medicaid swap. They do value, and it should be valued highly, the offer to take over medicaid. If the Congress would act favorably on that, it would be relieving the States of the most rapidly growing expense, the one most responsive to Federal problems, and the like.

What is before us, really, is a proposal which would be an evenhanded swap. The Federal Government would not inherit an additional dollar of burden. In our judgment, neither should the States. So the proposal is going along the lines that you mentioned. If it were to be acceptable to the administration, the States would take over a package of responsibilities from among the 500-some categorical grants that now address those areas, which would equal in cost the additional burdens to the Federal Government of medicaid.

Senator **Bradley**. As I understand the proposal, though, there will be a mismatch in funds when you get out to about 1988 or 1989. Did the Governors read it that way?

My concern is that we would be simply sending programs back to you without appropriate funding resources, and you would be raising property taxes. That wouldn't be good for you, would it?

Governor **Snelling**. No, that's not our idea. Our idea is that we preserve the, we think, constitutionally intended concern for capacity. So we believe that a trust fund ought to be established, and the trust fund ought to send—without any winners or losers—enough dollars to the States so that they could in fact bear the burdens.

One specific area in which the Governors' position differs from that offered by the President is, we don't believe that the trust fund should just automatically die leaving each State on its own. That would clearly be inequitable. The prime example is, if both Utah and Nevada were allowed to assess liquor excise taxes, that would not be of equal benefit to the two States, for all kinds of reasons.

Senator **Bradley**. You just made a very controversial statement. You have just advocated the permanence of the windfall profit tax.

Governor **Snelling**. No, I didn't advocate any such thing.

Senator **Bradley**. Well, don't the windfall profit tax revenues go into this trust fund?

Governor **Snelling**. Senator, the other point of disagreement is on the source of funding for the trust fund. You are referring only to one possible source of funding for the trust fund.

Senator **Bradley**. The last question I have is: Is this timetable realistic? If we make a sorting out of program responsibilities, will it be possible to begin to make these shifts back to the States in 1985? Can you get ready for the shifts if, say, the Federal Government takes the individual assistance programs and shifts the institutional programs back to you? Can you make that timetable?

Governor **Snelling**. With the caveats that are in the Governors' proposal as to protection of capacity, if in fact there were no winners or losers on the initial swap, if the burden which went to the States was proportional to the burdens that they were relieved of, there is no reason why such a thing shouldn't be undertaken in 1984, as a point of initiation, and why that would not in fact relieve the Congress of the United States of what otherwise will be some of their most pressing burdens of budgeting in that time.

Senator **Bradley**. Well, let me say that I thought the President's suggestions initiated a debate that's long needed. I think it will be completed sometime in the 21st century, but I think it is a very helpful debate.

I would like to think we could get it all sorted out, and I think under the able leadership of the chairman of the Finance Committee we will certainly do our share to federalize medicaid and welfare.

The **Chairman**. I think the States are very anxious for us to take medicaid. We are just trying to find something they are anxious to have.

Governor **Snelling**. We are prepared to do that, Senator, on a full dollar-for-dollar matched basis.

The **Chairman**. Right. And it may not be food stamps. I find some problems there, dividing that up 50 ways.

Governor **Snelling**. We hope it won't be.

Senator **Grassley**. I would like to express a thought—I don't have a question—in regard to what I hope the dialog on new federalism will include.

Unlike the present, where we have talked about what programs the Federal Government administers and what are jointly administered and what might go back to the States, of what might be retained by the Federal Government—that debate has centered around the administration of programs and almost what I have interpreted to mean a status quo as far as the programs and the level of spending of the programs—I think part of this dialog ought to include abandoning the assumption that we would maintain the existing level of expenditure and the existing number of programs; as if, just who is going to administer them? Because I think the total level of expenditures and the total accumulation of programs and whether they ought to exist, at what level, and whether they ought to exist at all—

I am not making any conclusions on it, but we ought to be discussing that, without the assumption that just because the States and local governments are going to take over everything that the present level of expenditure is going to be maintained and that the programs are going to be maintained. You know, some might be maintained, others abolished; some might have more increases in expenditures, some less. But I don't think we have really centered on the totality of it at the Federal level, and whether the totality ought to exist or something less or more at the State and local level. And I think it ought to be part of the debate.

Governor **Snelling**. Thank you.

The planned division of labor here was that I was going to discuss federalism and Governor Matheson was going to discuss the proposed 1983 budget. And I am very glad that my colleague has arrived.

I hope you heard the statement by the Senator and are instantly prepared to respond.

Governor **Matheson**. I think perhaps I'll get my breath, and then maybe I'll ask for you to summarize that question for me, because I just did arrive.

Governor **Snelling**. It really wasn't a question, and I don't know whether you have to respond. I would encourage you to, if you want to. I am not going to be able to stay and listen to your response, because I have to go to another meeting now with the University of Iowa people.

Governor **Matheson**. All right.

Governor **Snelling**. But you can read it from the record.

TESTIMONY OF GOV. RICHARD A. SNELLING

Senator Dole and Members of the Committee:

My name is Richard A. Snelling, and I am the Governor of Vermont. I am currently serving as Chairman of the National Governors' Association and am here as a representative of NGA today. Accompanying me is Governor Scott Matheson of Utah, who will succeed me as Chairman of NGA. It is our plan that I will concentrate on the President's federalism initiative, and with a number of discretionary grant programs under the purview of your Committee. Governor Matheson will concentrate on the effect of the FY 1983 budget on entitlement programs which are the joint responsibility of the states and the federal government. The two are interrelated, however, and our testimony will, I hope, make that point.

Before proceeding with that general division of labor, I would like to make a few comments designed to place the statements we are delivering to you today in a common framework.

The importance of the decisions which this Congress will be making in the weeks ahead may very well be unparalleled in the modern history of this nation. Seldom before has a sense of perspective been so essential to the likelihood of a satisfactory outcome. President Ronald Reagan has correctly identified three separate but related tasks which the nation must promptly address. These are:

1. to restore the nation's economic health;

2. to rebuild our defenses; and

3. to recapture that fundamental sense, upon which all other strengths depend, that our government is "of the people".

Each of the three urgent national agendas is separately an essential goal, but they are also interrelated.

A strong defense cannot be obtained by the purchase of arms at a rate that endangers the economy. It is the economy which must support the capacity for defense.

Neither a strong economy nor a strong defense can be achieved unless the the public has confidence in the competence and fairness of the government.

Since President Reagan's election, it is his proposals which has been determining the shape and substance of the national debate. We have, quite properly, put aside debate on how fast taxes can increase and instead we are debating how fast they can decrease. We are no longer allowing defense spending to become a dwindling portion of the budget; we are considering how fast it should increase to afford the requisite security. And, for the first time in a half century, the nation is discussing how to return greater responsibility to state and local governments.

It is the duty of the nation to pick up the President's charge and phrase a response in harmony with a national sense of what will be worthy to endure. Mr. Chairman, you have a critical role in this endeavor, and I want you to know that the Governors are prepared to work with you in any way you would find helpful.

FEDERALISM REFORM

Let me turn now to the federalism reform opportunity before us. While I realize that this Committee is most immediately concerned with recommendations on the FY 1983 Budget, the President's federalism initiative provides an important new framework for those decisions.

Before turning to the specific action taken by the Governors at our winter meeting last month, Mr. Chairman, I believe it would be helpful to discuss for a moment why we feel that progress on intergovernmental reform is urgently needed. Although the grant-in-aid system has certainly done much to alleviate poverty in this country, to strengthen the nation's capital infrastructure, and to advance social goals, all the evidence now points to the need to re-examine the intergovernmental partnership. An eleven volume study recently published by the Advisory Commission on Intergovernmental Relations concluded that the federal system is overburdened. Indeed, we all know that it is. With our hands tied by 500 separate categorical programs and their attendant regulations, over 1000 separate mandates on state and local government, and a paperwork burden estimated to cost $5 billion in 1977, we are not surprised that many Americans simultaneously believe that government is not meeting their needs and that it costs too much.

Governor George Busbee described the confusion of roles and responsibilities in the current intergovernmental system as follows: It is "difficult to imagine an issue too local or parochial to avoid the attention of Washington policymakers. Pot-hole repair, fire fighting, garbage disposal, building codes, have all been the subject of solemn deliberations on the Potomac...to a point where the Congressional Record sometimes bears an uncanny resemblance to the minutes of a county commission meeting."

In view of the urgency with which the Governors view the intergovernmental situation, we welcome the priority that the President has placed on the issue by speaking about it so extensively in his State of the Union address. By his action, the President has elevated federalism reform to a topic of national debate. The action taken by your Committee will have a major impact on the structure of the Congressional response.

NGA policy sets forth many federalism principles and guidelines that are compatible with the President's federalism initiative. We are in full accord with his proposal for federal assumption of Medicaid. We also welcome his far reaching suggestion that a range of categorical programs be transferred to state responsibility. And we believe, as does the President, that a mechanism for financial transition is essential.

The President's federalism proposals contain some elements that are not consistent with existing policy positions of the National Governors' Association, such as assigning responsibilities for food stamps and AFDC to the states. However, we feel these differences can either be reconciled by negotiation or temporarily set aside as we build a program based on existing areas of mutual agreement. To this end, NGA and the White House have begun negotiations on the federalism legislation to be submitted to Congress.

In preparation for these negotiations, the Governors worked at the winter meeting to identify areas of consensus and to develop a federalism initiative premised on the areas of agreement. Governor Matheson had a lead role in crafting this compromise. Our proposal is as follows:

1. The federal government would assume full responsibility for Medicaid. The exact savings to the states would depend upon the fiscal year 1983 appropriations levels and the services actually assumed by the federal government.

2. The AFDC-food stamp portion of the original proposal would be deferred for further negotiations. The states will continue discussions on the details of a later proposal for AFDC and food stamps.

3. The states would take over some negotiated set of federal categorical programs (excluding transportation programs). Decisions on programs returned to the states will be made in a spirit of partnership and cooperation with local governments.

4. During the first year, states would be required to fund all programs at the previous year's level. Over the next three years, states would have full discretion over the use of the funds.

5. The transportation programs and the highway trust fund would be dealt with separately, to recognize the unique relationship that has existed between user fees (e.g. the motor fuels tax) and transportation initiatives and the desirability of separating human capital and physical capital programs.

6. Because of the cost to the states of the returned programs is in excess of the federal government's estimated cost to assume Medicaid programs, a trust fund would be created at the level of swap difference. The trust fund would not increase in size, and would be funded from any federal revenue sources.

7. During fiscal year 1984, distribution of the trust fund would be based on historical expenditure levels to hold states harmless. In fiscal year 1985, 20% of the fund could be distributed according to the fiscal capacity of the states; in fiscal year 1986, 40% in fiscal year 1987, 60%; in fiscal year 1988, 80%; and in fiscal year 1989, 100% could be distributed based upon fiscal capacity.

8. In fiscal year 1989, the President and Congress would re-evaluate the total amount required for the trust fund and determine the most efficient manner to allow the states to retain the appropriate revenue base for returned services.

Mr. Chairman, this last point is an important one. We shouldn't start down the program turnback and trust fund phaseout road without considering where it ends. We are not a nation of separate, sovereign, self-sufficient states. I con't believe the founding fathers saw it that way and certainly no thoughtful person would see our nation that way today. We are enormously impacted as states by national policy, our own historical development, interstate migration, and the luck of the draw as to where natural resources in current demand are located.

Mr. Chairman, it is not conceivable to me that the end of this federalism road is the turnback of responsibility for the domestic affairs of this nation with the resources to pay for them left to the 50 states to work out for themselves.

Just as the President, with his Medicaid proposal, has moved in our direction, we have moved in his:

First, we have agreed to take over a substantial portion of the grant-in-aid system without guarantees of permanent funding. The President proposed a $30 billion swap. We have accepted his proposal.

Second, we have accepted the concept of a trust fund that does not increase in size. This position would have been unthinkable before this year.

Third, we have agreed to discuss an issue which arises in Congress whenever reauthorization of major programs is debated on the floor. I refer here, of course, to the formulas through which federal funds are distributed to the states. As you know, this is a divisive issue. However, many students of federalism agree that restructuring of the system cannot take place without review of the current distribution of funds. Our proposal addresses this issue.

Finally, we have agreed to defer for further negotiations the AFDC-food stamps portion of the original proposal. There is a strong consensus on the historic NGA policy position that income security is a federal responsibility. This policy was reaffirmed by the Governor last month. State assumption of food stamps--now a fully federally-funded initiative--and AFDC is antithetical to this policy. But we have agreed to continue discussions on AFDC and food stamps.

DISCRETIONARY PROGRAMS

Now I would like to turn briefly to the discretionary grant programs which are under the jurisdiction of the Finance Committee.

If the President's projections are accepted by Congress, aid to states and local governments will drop from 15.9% of the federal budget in 1980 to 9.6% in 1985. Spending on education, training, employment, and social services will drop 20%. The block grant programs, which support such important activities as maternal and child health, rehabilitation, alcohol and drug abuse, and child welfare, will be cut 15.7% on top of 13.2% cut last year.

Three programs deserve special mention. First, the FY 1983 Budget again proposes to reduce funding for the low income energy assistance program by over $500 million and to count the remaining funds in determining eligibility and benefits in the AFDC and food stamp programs. As you know, Mr. Chairman, this program was designed to offset the increase in energy costs that resulted from decontrol. While we have seen some stabilization of oil prices, we have also seen rapid increases in the cost of natural gas. There has not been sufficient time for basic aid programs to adjust to these increases and continued assistance is needed. Equally important, these payments for special needs should not be used to reduce payments for the basic needs provided by food stamps and welfare.

Second, the FY 1983 Budget recommends that the Social Service Block Grant be reduced by some $426 million and funded at a level of $1.974 billion. This cut would leave social service funding some 34 percent below its FY 1981 level. These reductions, when combined with other proposed reductions in WIN funding and employment and training programs, will seriously hamper state efforts to assist welfare recipients in becoming self-sufficient. In addition, other vital services such as those which help to reduce the need for institutional care will also be reduced. Such changes will work real hardship on individuals in need of service and may, in the longer term, actually increase governmental expenditures on the more costly entitlement programs.

Finally, the FY 1983 Budget proposes a new child welfare block grant to be funded at $380 million. We are concerned that this funding level, a cut of over 27 percent from FY 1981, will be inadequate to assure the availability of the needed array of preventive and foster care services for abused, neglected or homeless children. This proposed funding reduction is particularly distressing in light of Congressional action over the past several years to develop a more comprehensive program designed to help children find permanent homes.

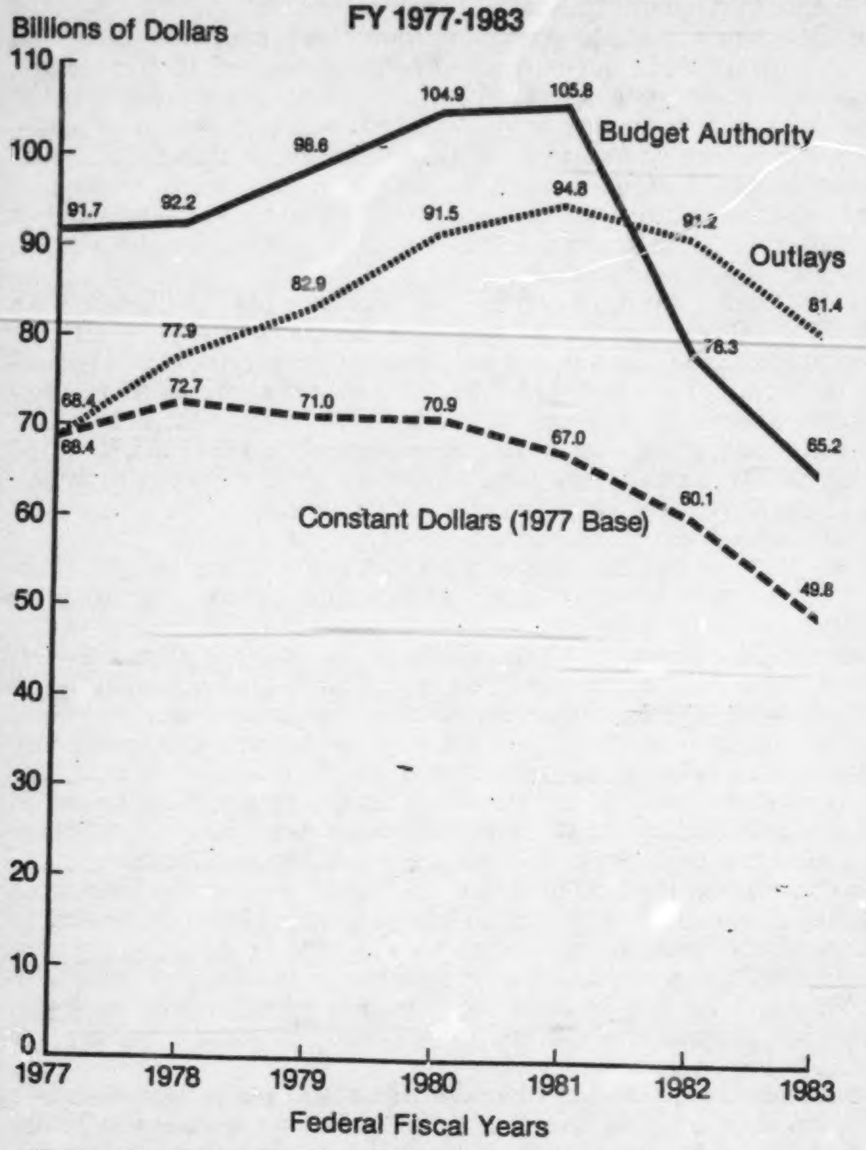
Mr. Chairman, citizens are complaining that government does not deliver for them now. In the judgment of the Governors, the cuts proposed by the Administration in these and other grant programs go deeper than the fat in the grants system. It is for this reason that we have called for level funding of discretionary grant programs in FY 1983.

Mr. Chairman, we agree that the economy is the major domestic issue with that Congress must tackle this session. But as I have pointed out, the important problems addressed by intergovernmental grants cannot be neglected. These problems will not be met by withered federal programs...programs starved for funds and flexibility...programs burdened by regulations designed for an era of growing appropriations and unsophisticated state and local governments. That is why we believe that the President's federalism initiative deserves immediate and serious consideration by Congress and that such an initiative must be based on funding levels no less than those provided in the current fiscal year.

Mr. Chairman, this Committee is in a unique position to reflect, through its discussion of functional spending levels for FY 1984, the commitment of Congress to address the current imbalance in the federal system. We hope your work will reflect support for enactment of federalism legislation that will permit Congress to focus on truly national concerns, that will untie the hands of state and local officials to deliver services they are best equipped to handle, and that will restore citizens' faith in their government.

Federal Aid to State and Local Governments

FY 1977-1983



Source: BA and Outlays OMB Special Analysis H.
Source: Constant dollars National Governor's Association

STATEMENT OF HON. SCOTT M. MATHESON, GOVERNOR OF THE STATE OF UTAH

Governor MATHESON. Thank you very much.

The CHAIRMAN. I might say, Governor Matheson, that under an unusual rule we were not permitted to meet beyond 12 p.m. today, because we have been involved in a special proceeding on the Senate floor. Not with any disrespect to Governors, we have asked Governor Snelling to summarize his statement, which he did, and if you could do the same it would be helpful.

I think since you are on the budget side maybe you could insert your statement, and I could ask a question or two for the record.

Governor MATHESON. Surely.

The CHAIRMAN. And, of course, we will be working closely with the National Governors Association and members of their staff.

I can understand the Governors' interest in picking up lost Federal subsidies, but we are told that the Federal share of social welfare expenditures grew from 48 percent in 1960 to 62 percent in 1979, while the State and local percentage dropped from 52 to 38 percent. So I think that's an area where we have got a big problem, too; I know the States have—maybe Utah doesn't have, and maybe Vermont doesn't have, but other States may have.

But we hope, if in fact we can work out some of our budget problems, that we can work with the States and not counter to your interests.

Governor MATHESON. I think, Senator, that the Nations Governors are most anxious to have the opportunity to work exactly on that basis with you and your committee. We are certainly pleased with the comments which you have made about the budgeting process. I don't believe that we are in a position where we wouldn't want to sit down and try, on a case-by-case, very practical basis. To solve the proposals I think that's the only way you can address these problems these days. And we want to do it on that basis.

The CHAIRMAN. And I think the fact that we have a Democrat and a Republican here this morning representing the Governors, to me, would be an indication of what we ought to be doing as we look at the budget this year, and I might add with the help of the President. We can't do this in isolation. The President, sooner or later, will need to provide the leadership and indicate some flexibility. It probably is too early now.

As I understand, you don't believe we should make any medicaid cuts in fiscal year 1983, that on top of some of the cuts made last year that would be disastrous in some cases. I assume you allude to that in your statement.

Governor MATHESON. That is correct, Senator.

We have felt that we need to have this year to absorb the cuts which we are involved in handling now, and examine it 9 years later in terms of what adjustments ought to be made.

I don't think we want to be stubborn about it; I think we are basically concerned about meeting the level of need. A transition year is one that is necessary to do so. Then we can examine what can be done and in an appropriate fashion. I think that's the process which we would encourage, and I think all the Governors feel comfortable about that.

The CHAIRMAN. Right. And I think one thing that we hope to do more of is communication. We start off in one direction which may be going the wrong way as far as Governors are concerned. Maybe, before we start in any direction, if we had the meeting, we would both be going in the right direction. We know we have to reduce the cost of government at the Federal, State and local levels.

But I am wondering, just one question that maybe you both could respond to: Why is it that some city and county officials seem to fear New Federalism, because they don't believe that Governors will look out for their interests—I don't mean that they will not be fair, but there is some doubt in their mind whether they will benefit as much under New Federalism because, I guess, of the top level in the State. That fear is not justified, is it?

Governor SNELLING. No, Mr. Chairman. We don't think it is. We think it's a ready explanation for the last decade or two, the place where the money was was in Washington. And mayors and local officials have been pretty well trained that, if they have a particular need, it might actually be easier, take less effort, to accomplish the enactment of a Federal piece of legislation to address that now than to have it tested in the arena, the local arena, of a State legislature.

I would certainly agree that legislatures must be fairly apportioned. But if legislatures are fairly apportioned, and we have any faith in the democratic system, I think we do have to assume that States can be fair and just partners and that they can deal with the responsibilities that they have to local governments just as fairly as the Federal Government is expected to deal with States.

The CHAIRMAN. I assume you share that view, Governor Matheson.

Governor MATHESON. Philosophically, I certainly do. I think it's fair to point out to you, however, that not all State legislatures nor State Governors have looked upon local problems and concerns and local elected officials in the spirit of getting the problems solved in instances in the past. And in some cases, I think the local units of government pulled the end run on the State and came here because that was the only choice they had to solve the problem.

But I think we have grown up and matured at the State level in the last 20 years to the point where we have a new capacity. I sense a totally different attitude about how to deal appropriately and fairly with local units of government.

I think that it is our responsibility, to assume that burden. And I, for one, and I'm sure Dick agrees with me, would like to solve those problems among us and not involve the Federal system unless it turns out that we are failures. And I think there is some concern on the part of mayors that we want to play the game that way; but I am certain the Governors are very anxious to do so.

The CHAIRMAN. Finally, I have people tell me, "Well, you can't take away this program; it affects handicapped," or mental health, or whatever, because State legislators and Governors aren't "as sensitive" as Members of Congress. Well, I don't subscribe to that. I think probably there is just as great a sensitivity and compassion at the State and local levels as there is at the Federal level.

Of course, nobody wants to cut loose. I think that's the problem. They are fearful that somewhere down the line their program may be lost as the State develops its priorities. Maybe it should be. Maybe you are in a better position to judge that than we are. That doesn't mean you lack sensitivity. I think that's a weak argument, but it's one we are going to hear.

Governor Matheson. I think the status-quo argument and the turf problem will be the biggest item, really, to overcome, when you are reexamining your priorities, when you don't have enough money to do it anymore. And that's tough. But I think the time and the opportunity is here for all of us.

The Chairman. Well, I would be prepared, if you would submit your statement, and I will be submitting questions through the association.

Governor Matheson. We will be happy to do that, Senator. If there is another time, and you feel it would be worth the committee's time, Governor Snelling and I would be pleased to come and present further testimony and respond to any questions that you think would be helpful.

The Chairman. All right. We hope by the end of this month to have completed hearings and be in the markup process, and at that time we may need some advice.

It is my hope that we can put together some package and add that as an amendment to the debt ceiling, in an effort to bring down the deficit and bring down interest rates. We know we are going to have to do that, and everybody is going to have to contribute, and we will be looking for contributors. So we will be looking to you, I guess.

Governor Matheson. As long as being a contributor doesn't mean we send money back to you, Senator.

The Chairman. Right. No; we just won't send quite as much to you. [Laughter.]

Governor Matheson. That would be fair enough.

Governor Snelling. Mr. Chairman, speaking strictly for myself and not on behalf of the association, I want to say that I personally commend you for the leadership that you have taken and for the statements that you have made about the need which, I agree with you, is obvious or should be obvious, that we do need to do something on the revenue side.

The Governors have not taken a position on that. How can we fail, however, as individual Governors to see the connection between the rate of interest and the strength of the economy and the capacity of the Federal Government to help us to meet our responsibilities?

Governor Matheson. And, indeed, I would like to echo that comment, Senator.

The Chairman. We are looking at every tax expenditure, about $280 billion worth, so we ought to be able to find a few billion dollars in that assortment. Plus, there are other areas in the bill passed last year, particularly the leasing provision. There are areas we can pick up—and even the so-called underground economy or the tax compliance. Those are areas that we should address, which may require some more reporting on behalf of the State with a report to the taxpayer when he gets his State tax refund. That may add some additional work in each State; but it means the Government can pick up about $330 million, which could fund some of these programs we hope to return to the States.

Thank you very much. We appreciate it.

Governor **Snelling**. Thank you for hearing us, Senator.

Governor **Matheson**. Thank you, Senator.

[The prepared statement follows:]

TESTIMONY OF GOV. SCOTT M. MATHESON

Mr. Chairman and Members of the Committee:

My name is Scott Matheson, and I am the Governor of Utah. As Governor Snelling has indicated, I will focus my remarks on the impact of the FY 1983 budget on the states. A recent NGA analysis of the budget will be supplied to members of Congress.

Fiscal hard times are already upon most states, before additional adverse impacts due to new federal budget decisions are even considered. The FY 1983 budget proposals and unanswered aspects of the President's federalism proposal would significantly weaken our capacity to meet the needs of our citizens directly and indirectly through our local governments.

But before we address the 1983 budget, it would be useful to review the states' experience in FY 1982. To begin with, states and local governments took a disproportionate share of the budget cuts in FY 1982. While we comprise only 12.6 percent of the federal budget, grants-in-aid budget authority was cut 26 percent.

For years, the governors have urged Congress to rationalize the current federal aid system through increased reliance on state and local laws and procedures, fewer mandates and regulations, more revenue sharing and block grant funding procedures. Last year's block grants were certainly better than dozens of programs for the same recipient and purpose, but only with flexibility and adequate funding.

Few governors will be interested in a replay of last year's experience. We proposed a one-time 10 percent cut and significant flexibility to target funds according to state priorities. What we got were 20 percent cuts and very little flexibility from Congress. Now further large cuts are proposed for FY 1983.

The states come before you to plead their case for equitable treatment in the FY 1983 budget with the 1982 experience behind them and a sagging economy before them. The states are anxious to see the nation achieve economic vitality. But we urge Congress to ensure that we are not asked to carry a disproportionate share of the burden. It might be helpful to provide some background for you on the current fiscal condition of the states so you can better understand our concerns about the FY 1983 proposals.

Fiscal Conditions of the States

At the outset, it might be helpful to provide some background for you on the current fiscal condition of the states so that you can better understand our concerns about the FY 1983 proposals.

With their revenues buffeted by the national recession, the majority of states entered 1982 either projecting deficits or teetering on the brink of deficit. Since states cannot legally operate in the red, many states face tax increases or large service cuts on top of a depressed economy. As one measure of fiscal condition, a year-end balance equal to five percent of annual spending has been considered a prudent cushion. However, according to a recent survey, 30 states in all parts of the country expect to conclude their current fiscal years in deficit or with a balance below one percent.

Nine other states forecast balances of one to five percent, and only seven predict balances of more than ten percent. Most of the states with large balances derive substantial revenue from their energy industries.

Although more than half the states raised taxes during 1981 legislative sessions, state budgets in 1982 are austere, suffering from sluggish revenue growth and increased recession related expenses. States are also finding that actual revenue is falling short of projections: 21 states indicated that revenue was below official forecasts, while only 10 indicated it exceeded the forecast. Since the recession worsened significantly after October, when this information was collected, the situation appears even more tenuous today. For example, Wisconsin originally responded to the survey saying it expected a balance of more than $53 million. But in late January, legislative and executive estimates of the deficit for the current biennium ranged from $377 million to $450 million.

Contributing to the problem has been the effect of the Accelerated Cost Recovery System (ACRS) which Congress enacted as part of the Economic Recovery Act of 1981. While NGA has not attempted to make estimates of the precise revenue impact of ACRS on the 44 states that are tied in some way to federal depreciation definitions, we know that the effect will be substantial. By some calculations, if all states adopted ACRS, state revenues from corporate income taxes in FY 1986 would drop nearly 40% (or $10 billion) from what they otherwise would have been in FY 1986. Given the magnitude of the potential loss, state officials will be reviewing their response with some care, and our decisions may change as our analyses are completed.

According to a survey undertaken by the National Governors' Association last month, it appeared that 20 of the 44 states affected expected to fully conform to the changed federal rules, 10 were conforming, but with modifications (such as raising the corporate tax rate to offset lost revenue or allowing only a portion of the depreciation exemption allowed under the federal law), 5 were not conforming, and 9 had not yet decided on a course of action.

FY 1983 Budget Proposals

In anticipation of the President's FY 1983 budget, the governors officially communicated their views to him in a letter dated December 4, 1981.

The FY 1983 proposed budget falls short on several important points which the NGA's Executive Committee endorsed in the December 4 letter to the President:

- the Executive Committee urged level funding of state and local "non-entitlement" programs in fiscal 1983 and 1984--the Administration's budget cuts such programs by $5.9 billion;
- the Executive Committee proposed that if discretionary programs were to be further cut, the reductions be balanced with comparable increases in the federal share of welfare, Medicaid, and other income security programs--the Administration's budget cuts these state-administered income security programs by $3.9 billion, including changes that reduce the federal government's current share of all these programs.

- the Executive Committee called for greater scrutiny of defense spending and tax expenditures and for even-handed treatment of direct federal entitlement programs, many of which are not based on need, and state-federal entitlements, where need is always a factor--the proposed budget increases defense by 18 percent, proposes only modest tax revisions, cuts direct federal entitlements by 2.2 percent and state-federal entitlements by 11.7 percent.

Importance of Grants in State-Local Finance

Governor Snelling has commented on several discretionary programs with the jurisdiction of the Senate Finance Committee. I would like to relate these comments to the broader picture of federal grants generally.

Table I, attached, shows the relative importance of grant programs in the context of state and local finance and the federal budget. If the FY 1983 proposals are accepted by Congress, they would turn back the clock on state-local-federal financial relationships to 1965 levels.

Another vivid indicator of the impact of FY 1983 proposals is the proposed level of budget authority for grant in aid. As Table II shows, using FY 1981 as a base year, grants proposed for FY 1983 would have only 53 percent of the purchasing power needed to maintain constant program levels. This would be a cut of 47 percent in purchasing power in just two years.

Mr. Chairman, you know that "state and local grants" do not go to governments; they go to the people of the United States. In 1980, about $105 billion was granted to state and local governments to address the income security, public health, clean water, job training, public education, economic development and hundreds of other concerns which affect citizens in the communities in which they live.

The 1982 budget made about $78 billion available for these programs and these needs. The national consensus apparently was that in the past funding for these programs had risen too fast, and had to be restrained. The question now is, how shall we determine the right level for intergovernmental expenditures?

I suspect that there are some good arguments to be made for continued improvements in managing and targeting these programs, but after close examination of who benefits from these expenditures, I am certain that $13 billion cannot be cut from grants to people through state and local governments while maintaining any true "safety net" for those in this country who genuinely deserve help.

These reductions in purchasing power are sizable enough to have a major effect on state and local governments, private providers of services paid with grants, and the recipients of services. How the losses are likely to be shared among these groups depends both upon the nature of individual cuts and the programs in which they are made.

As was the case with the FY 1982 cuts, it is likely that a substantial percentage of these cuts will, of necessity, be "passed through" state and local governments, so that the ultimate effects will fall upon service recipients. States are largely unable in the current economic climate to increase taxes to the extent necessary to replace lost federal funds.

Impact of Entitlement Cuts

The Administration has also proposed substantial reductions in the needs tested entitlement programs of AFDC and Medicaid. We are concerned that needs tested entitlements have not been treated fairly when compared to other entitlements. For example, OASDI is projected to grow from $155 billion in FY 1982 to over $200 billion in FY 1987. Over the same period, the Administration will cut AFDC and Food Stamps from $19.3 billion to $15.6 billion. This reflects not a reduced growth rate as suggested by Secretary Schweiker but a concerted program cut. At the same time, Medicare will grow by almost over 37%, while Medicaid will grow by only 15%.

In my view, we have excessively reduced support for the poor and for federal service programs administered by states. These programs are critical and must be continued. It is fair and essential that the Finance Committee consider the imbalance in past reductions in federal spending on the poor and the services they rely on. It is vital that the Committee develop spending targets that recognize the serious reductions these programs have already sustained.

While I understand that you will consider substantive legislation at a later date, I think it is important to address some of the specific changes as you discuss your more general strategy. First, it is important to recognize that the Administration's proposals seek reductions in three different ways:

(1) changes in program structure which are generally designed to encourage more efficient service, the more prudent use of medical care and the maximum use of available resources;

(2) cost shifts from the federal to the state and local levels through error rate sanctions, reduced administrative costs, reduction in matching rates and the end of federal participation in costs such as Part B Medicare Insurance.

(3) reductions in benefits to recipients with other available income or resources to offset these levels.

We can, in general, support program changes such as prospective hospital rate setting in Medicare and optional copayments which are designed to maximize the efficient use or provision of service without denying needed assistance or shifting costs to other levels of government. We must, however, strongly oppose changes such as the proposed error rate tolerances, the combined grant for welfare administration and reduced matching rates for optional Medicaid services which merely shift costs to the states. We also are concerned that further cuts not be directed toward those least able to afford them.

Proposed AFDC Changes

In the AFDC program the FY 1983 budget is based upon an additional 15 changes to be made in the federal standards for the program. These revisions are projected to save $166 million more in FY 1982 and $1.55 billion in FY 1983, putting total federal AFDC expenditures in FY 1983 some $2.2 billion below the FY 1982 level. The major changes to be imposed would (federal savings in parenthesis):

- require community work experience programs (CWEP) in every state and mandate CWEP participation by unemployed parents ($135 million);

- mandate job searches for AFDC applicants ($145 million);

- eliminate the WIN program ($245 million);
- prorate shelter costs for shared households ($174 million);
- reduce benefits to reflect energy assistance as income ($175 million);
- count income of unrelated adults living with AFDC families ($69 million); and
- eliminate reimbursement on erroneous payments over 3% ($234 million).

Effects of the Proposed AFDC Changes on the States

The federal government assumes that most of these changes will produce comparable savings at the state level through benefit changes or caseload reductions. But some of the changes, such as the exclusion of a parent when the youngest child reaches 16, assume the availability of employment opportunities, and others, such as prorating of rent or broader eligibility units, assume that persons will voluntarily contribute to the care of children for whom they have no legal responsibility. To the extent that jobs are not found or contributions are not made, the state may have to pick up those costs not eligible for federal reimbursement.

In addition, the proposed program changes would substantially increase administrative costs. This is particularly true for work relief and job search programs while the WIN program is eliminated and federal aid for administrative costs is capped through the combined welfare administration grant. Efforts to reduce errors to the new 3% target will also require additional unreimbursed state administrative costs. Moreover, it is unlikely that the proposed

3% error rate targets can, in fact, be reached during the next fiscal year. The large number of program changes made over the past year may actually increase error rates while attempting to reduce total expenditures.

The requirement that energy assistance benefits be counted in calculating AFDC essentially denies such recipients any benefit from the program. States may be subject to substantial pressure to increase basic benefits to make up for this loss and for reduced food stamp bonuses that result from the higher benefit reduction rate applied to welfare benefits.

Proposed Medicaid Changes

In the Medicaid program outlays of $17.0 billion are proposed for FY 1983, $2.0 billion under the FY 1983 current services estimate of $19.0 billion. Also, $200 million in reductions from FY 1982 current services outlays are proposed.

Almost half of the proposed FY 1983 Medicaid savings are from reductions in federal Medicaid matching rates. A $600 million reduction would be obtained by reducing each state's matching rate by three percentage points for optional health services (e.g. drugs) provided to categorically eligible recipients and for all services for the medically needy. A savings of $203 million would be achieved through elimination of federal matching funds for state payment of the Medicare Part B premium. In addition, a federal expenditure reduction of $64 million results from a proposed cut in the matching rate for family planning services from the current 90% down to each state's normal Medicaid matching rate (i.e., from 50 to 78%, depending on the state) and from a reduction in the matching rate for state certification activities from 75% to 50%.

A federal requirement for cost-sharing by Medicaid recipients is estimated to result in FY 1983 federal savings of $329 million. Proposed federal legislation would establish a $1 and $1.50 per visit co-payment for the categorically and medically needy, respectively, for physician, clinic and hospital outpatient department services. In addition, a $1 (categorically needy) and $2 (medically needy) co-payment per day would be required for inpatient hospital services.

Legislation to enhance state ability to recover costs from deceased recipients' estates, and to allow states to require that adult children of institutionalized Medicaid recipients contribute to the cost of their parents' care, would achieve an estimated federal savings of $183 million. An additional $100 million savings would be realized through regulatory changes to allow states to recover long-term care costs from relatives.

A $59 million federal savings is budgeted for the phasing in of a 0% eligibility error rate. As in AFDC, the current 4% eligibility error rate target is to be reduced to 3% in 1983, 2% in 1984, 1% in 1985, and 0% in 1986.

In addition, a $75 million savings is included in the proposal to reduce to one month the eligibility extension for recipients who lose AFDC eligibility because of earned income.

Effects of the Proposed Medicaid Changes on the States

The proposed changes in Medicaid would shift substantial federal costs to the states. The impact on a given state of the three percentage point reduction in federal matching funds for optional services and services for the medically needy will depend on the scope and composition of the state Medicaid program structure. It should be noted, however, that intermediate care facility services, which account for about 27% of Medicaid vendor payments nationally, are technically an "optional" service. In a number of states with very tight eligibility and service coverage policies, intermediate care facility services account for an even larger proportion of program expenditures than the national average.

The proposal to eliminate federal matching funds for state payment of the Medicare Part B premium would directly increase state costs by the $203 million federal "savings." The elimination of special matching rates for family planning services and state certification activities would shift an estimated $64 million in federal expenditures to the states.

The mandatory co-payment proposal is intended to reduce the unnecessary use of medical services and should result in both federal and state savings. States have pressed for latitude to implement nominal co-payments for mandatory services, with the ability to apply selective co-payments only to certain services, diagnostic groups and settings. While the Administration's proposal would implement co-payments for mandatory services, it would not give states the policy latitude desired.

States would share in the savings from the proposal to give them flexibility to recover long-term costs from recipient estates and to require adult children to contribute to the cost of their parents' care in nursing homes. States have asked the Administration and Congress for the ability to recover these costs. The savings obtained in each state will depend entirely upon state policies and programs.

We are concerned that the reduction from four months to one month in extended eligibility for clients dropped from AFDC may have an adverse impact on client behavior. The four-month Medicaid eligibility extension is intended to improve incentives for AFDC recipients to work. If fewer AFDC recipients obtain jobs because of the more immediate loss of Medicaid benefits, this proposal will increase federal and state costs.

Proposed Welfare Administration Grant

Finally, let me make a brief comment concerning the proposed combined welfare administration grant.

Under current law, states are eligible to receive federal reimbursement for all necessary expenses involved in the administration of the AFDC, Medicaid and Food Stamp programs. In general, the reimbursement level is 50% of costs, although some special priority activities are reimbursed at a higher rate. As proposed by the President, administrative reimbursement under the three state-administered programs would be consolidated into a single grant and capped at 95% of the FY 1982 level. State matching would be eliminated as would some of the detailed cost allocation requirements found in current regulations. Some higher matches in fraud control would be retained, although the details are not specified.

The budget estimates that the cap will save the federal government $307 million in FY 1983. But these project savings are simply costs to be assumed by the states unless they are able to reduce overall administrative costs accordingly. Such reductions are extremely unlikely in the face of new administrative requirements contained in the budget. The loss of WIN funding and new work requirements could substantially increase costs, as could expanded error reduction efforts needed to avoid sanctions.

The proposed limitation of federal reimbursement appears counterproductive at a time when we need to pay greater attention to improving the accuracy and effectiveness of these vital programs. The limitation may be particularly unfair to states which have made multi year commitments to acquire data processing equipment and may seriously hamper additional computerization in the near future.

Conclusion

Mr. Chairman, from this testimony I think you will see that the Governors recognize the importance of budget constraints and the difficult decisions you must make. We appreciate the opportunity to comment at this early stage and hope to consult further with the Congress as it considers detailed legislation. We will oppose many of the proposed FY 1983 budget cuts. We believe that block grants should not be cut beyond FY 1982 reconciliation levels. We are concerned that the integrity of needs tested entitements be maintained. We are concerned that defense and indexed entitlements share the burden of restraint. We also feel that tax expenditures should be carefully scrutinized.

We look forward to working with you to develop a sound budget policy that stimulates the economy and preserves the programs that the American people rely on to meet their most basic needs.

Table I

Grants in Relation to Total Budgets

	Grants as Percentage of	
Federal Fiscal Year	Federal Outlays	State/Local Budgets
1965	9.2	15.3
1970	12.3	19.2
1975	15.4	23.0
1980	15.9	26.3
1981	14.4	25.3
1983	10.7	18.3
1985	9.6	16.1

Table II

Grant Allocations in Relation to Purchasing Power
($ billions)

	Budget Authority	Outlays
FY 1981 Actual	$105.8	$ 94.8
Amount required in FY 1983 to Maintain FY 1981 Purchasing Power	122.7	110.0
Amount in Administration Budget, FY 1983	65.2	81.4
Administration Recommendation as Percent of Amount Required to Maintain FY 1981 Purchasing Power of Grants, FY 1983	53%	74%

Mr. CHAIRMAN. According to the schedule, we would now have a panel consisting of Dr. John Albertine and Dr. Richard Rahn. There is this 12 deadline. I don't think I would go to jail if we go beyond it, but I am not certain what does happen.

As I understand it, Dr. Rahn would be willing to come back next Tuesday?

Dr. RAHN. Yes, sir.

The CHAIRMAN. And Dr. Albertine has a conflict, as I understand, next Tuesday.

Dr. RAHN. We could submit it for the record, if we can.

The CHAIRMAN. If you could come up maybe briefly, we have about 5 minutes.

Dr. RAHN. I think Dr. Albertine and I can give our statements probably within a minute apiece, if you would like, sir.

The CHAIRMAN. Oh, fine. Well, you would go to the top of the list as to people to be called back, if you can do that.

Dr. Albertine, I think you are listed alphabetically here. Are you both supply-siders?

Dr. RAHN. We agree with each other. He's a mighty fine economist.

Dr. ALBERTINE. The only differences we have, Mr. Chairman, are in the areas of tribal loyalties—Richard is a Republican, and I'm a Democrat.

STATEMENT OF DR. JOHN ALBERTINE, PRESIDENT, AMERICAN BUSINESS CONFERENCE, WASHINGTON, D.C.

Dr. ALBERTINE. I can summarize in 15 seconds.

The only point that the American Business Conference would like to leave with this committee is that there is a view abroad in the land that if you defer the third year of the personal tax cut enacted last year that you will, by definition, lower the fiscal year 1984 deficit.

We would simply argue that that is not unambiguously clear, that you may in fact raise the deficit. And so, we would urge caution with respect to any movement by this committee in that direction at this time.

STATEMENT OF DR. RICHARD W. RAHN, VICE PRESIDENT AND CHIEF ECONOMIST, CHAMBER OF COMMERCE OF THE UNITED STATES, WASHINGTON, D.C.

Dr. RAHN. I totally concur with that, Mr. Chairman.

Just two quick points: First, a major way of reducing expenditures is by freezing COLAs for fiscal year 1983. That would save about $24 billion and would just about offset the $21 billion in overpayment of COLAs from 1978 through 1981. In our statement we have provided an extensive discussion of this proposal.

Secondly, we would be strongly opposed to any major tax increases at this time. We feel it would be counterproductive and would slow down the rate of economic recovery. Every simulation we have done shows it would reduce both economic growth and real percapita incomes for all of our citizens.

The CHAIRMAN. I might ask each of you a question.

Do you see any pickup in business activity because of the tax bill passed last year? We have heard a lot of criticism. I know we are in a recession. A lot of people are saying, "Well, the Fortune-500 or business ought to get with it. We have given them the tools, and they haven't responded." If you see any pickup, I would appreciate having that said for the record. If not, when do you anticipate it?

Dr. **Albertine**. Well, Mr. Chairman, I have got a hundred members, CEOs, around the country, and I talk to them daily. The truth of the matter is that the recession is clearly bottoming out. Over the last month or so, our members are reporting that economic activity in fact is picking up. And they do expect a recovery to be in full swing during the summer months.

Dr. **Rahn**. I totally concur with that. Our estimates are that the economy probably hit bottom in late January or early February. Indications are we are indeed coming out. As capacity utilization starts to increase, I think you will see a sizable pickup of capital investment.

We do frequent surveys of business confidence, and we will of course foward them on to you.

The **Chairman**. Do both of you expect the interest rates to continue a downward trend in the next few months?

Dr. **Rahn**. We do. When you are forecasting interest rates, you are essentially forecasting the behavior of the Fed. Our indications are that the money supply is under better control than it had been in December and January period. In talking to Wall Street people, our bankers, and others in the financial community, we find they all expect interest rates to fall rather substantially over the next few months. That, of course, will help out autos, housing, consumer durables, and so forth.

Dr. **Albertine**. We just did a poll—I don't want to announce it here——

The **Chairman**. Go ahead, I won't tell anyone. [Laughter.]

Dr. **Albertine** [continuing]. Of the financial community, Senator, that the chairman of the American Stock Exchange will announce this week. It is clear that the overwhelming sentiment among the financial community is that interest rates in fact are on a secular decline in this economy.

The **Chairman**. Well, I share the view that I think you have both expressed as far as the third year tax cut is concerned. I don't see any reason to even talk of jettisoning that tax cut. I don't believe it would have the intended effects. It would take the pressure off Congress to reduce spending. If that is the effect we are looking for, obviously we would repeal all of the tax cut, and then we wouldn't have to do anything.

Dr. **Albertine**. Right.

The **Chairman**. But there have been some options suggested. Let's just take the scenario that some in Congress will not compromise unless we do something the third year. Others will say we will not compromise if we do anything the third year. Well, it seems to me that in that case one possible option might be to speed up the indexing proposal so both sides could claim victory. Now, that may or may not be necessary. I am not advocating that; I am suggesting that that would appear to me to be something that might be addressed.

Do I understand that both witnesses are in favor of either repeal or modification of the leasing provision?

Dr. ALBERTINE. We are in favor of repeal, Mr. Chairman.

The CHAIRMAN. Total repeal?

Dr. ALBERTINE. Yes, sir.

Dr. RAHN. We are not in favor of repeal. Some modification might be in order, but our existing policy position is to support leasing. If a clear and demonstrated abuse can be shown, we would of course consider some modification.

The CHAIRMAN. I visited briefly with Dr. Lesher yesterday, and he indicated that, "You realize that you, in effect, stopped the leasing program with a press release?"

I said, "Well, it would seem to me if the program is not working well and we have a chance to save a couple of billion dollars, that we ought to do it. And if I could save a few billion more, I would put out another press release. It would make our job a lot easier."

He said that not in a hostile way, just in a friendly way—I think. [Laughter.]

The CHAIRMAN. We were attending a roast for someone you know. Thanks for the flowers, by the way.

Dr. ALBERTINE. Yes, sir. Someone of great eminence.

The CHAIRMAN. Yes.

Dr. RAHN. Well, actually, we think of leasing as working rather well. Without it, you would have had additional numbers of distressed industries and firms. There have been considerable benefits associated with it. I don't think these ought to be overlooked.

The CHAIRMAN. I don't suggest, again, that we ought to throw the whole thing out. We have about 20 options now that the Joint Tax Committee and our committee staff have prepared from some conversations with both of you, I think.

So if in fact it works, those portions ought to be retained. Where it doesn't work, where it is just a gift to someone and there is no response to that as far as more productivity, more jobs, more expansion, then I think we might as well save the money. We don't have much of it. Had we not had the recession, nobody would have noted leasing. But we are looking desperately for a few billion dollars, and I guess that highlights anything that may appear to be too generous.

Well, your entire statements will be made a part of the record, and I appreciate your willingness to do that. We will be working with you and members of your staffs in the next few weeks.

Dr. RAHN. Thank you, Senator.

Dr. ALBERTINE. Thank you, sir.

The CHAIRMAN. Thank you.

[The prepared statements of the previous panel follow:]

TESTIMONY OF DR. JOHN M. ALBERTINE
PRESIDENT OF THE AMERICAN BUSINESS CONFERENCE
before the
Senate Finance Committee
March 11, 1982

Mr. Chairman and Members of the Committee:

It is a pleasure for me to have the opportunity to appear today before this distinguished Committee.

The American Business Conference is a relatively new organization limited to the chief executive officers of 100 of America's most successful and energetic firms. These firms have annual revenues between $25 million and $1 billion, and each has doubled in size over the last five years. They are located in all parts of the country and represent the full spectrum of American commerce.

The American Business Conference has a message for America. In spite of our country's current economic problems, the entrepreneurial spirit, which made our country the most prosperous in the world, is still alive. There still are American risk takers who even now are creating jobs and improving the quality of the American industrial machine. The members of the American Business Conference do not believe that America's economic might is in inevitable decline. They have a shared sense of public purpose to help create an economic climate which will make more success stories possible.

The entrepreneurs of the American Business Conference believe that our country's future economic prosperity depends critically on the adherence by the Federal Government to the traditional American philosophy which allows market forces to allocate our nation's resources.

While the American Business Conference has generally been very supportive of the Reagan Administration's spending and tax initiatives, we are increasingly concerned about the size of budget deficits. Deficits of the magnitude currently predicted by the Office of Management and Budget increase the risk that long-term interest rates will remain unacceptably high. Continued high interest rates could result in a slow, uncertain recovery, rather than a rapid and vigorous one.

Mindful of the dangers inherent in high deficits, the members of the American Business Conference believe that further efforts must be made to eliminate wasteful spending practices -- whether they occur in the civilian agencies or the Department of Defense. The American Business Conference also favors a review of federal "entitlement" programs, including social security, to bring benefits in line with the resources available to fund these programs. In a recent survey of the American Business Conference membership, over 80% supported restructuring the cost of living adjustments for Federal entitlement programs.

The demographics indicate that, in future years, fewer workers will be supporting more retired persons. Under these circumstances, benefits cannot continue to increase faster than wages. Restructuring the cost of living adjustment of social security benefits can restore the solvency and reliability of the system. Failure to restructure the COLA's could threaten the viability of the social security system as well as imposing growth-inhibiting deficits on the entire economy.

The American Business Conference feels that spending must assume most of the burden of deficit reduction. The American Business Conference believes that the productivity performance of the economy will be enhanced as resources move from the public to the private sector. It is important to remember that increased productivity is the only way that the real standard of living of all Americans, including disadvantaged Americans, can be raised.

The American Business Conference is not prepared to support rescinding or deferring the personal tax cuts voted by the Congress last year. The economy is still in a recession, and current evidence suggests that, absent the July 1982 tax cut, the recovery will be far from robust. In addition, postponing the tax cut scheduled for July of 1983 may or may not lower the FY 1984 budget deficit. Indeed, it would be imprudent at the present time to attempt to guess whether the economy will need the stimulus of the tax cut scheduled for July of next year. In a recent survey of our membership, only about a quarter of American Business Conference members viewed the postponement of the personal tax cuts as an effective means of narrowing the budget gap. The American Business Conference continues to believe that the deficits will not drop significantly without a strong economy, and a strong economy is predicated upon the absence of disincentives to economic revitalization.

The American Business Conference has gone on record as opposing safe harbor leasing. The American Business Conference believes that leasing is an inefficient, expensive means of stimulating growth in our capital stock. The American Business Conference does not believe that the leasing mechanism has operated as the Congress intended.

Later this year, when you consider changes in the corporate minimum tax, the American Business Conference would like to remind you of the importance of retaining incentives for economic success. Do not let the budget crisis facing this nation tempt you to abolish existing incentives. The Administration's projected deficits are not driven by the tax reductions enacted by the Congress last year. Nor are increases in Federal spending at fault. The high deficits are driven by slow economic growth. A return to the old economic policies, which effectively discouraged economic growth and thwarted entrepreneurship, would be equivalent to signing a death warrant for America's economic vitality.

Thank you.

STATEMENT
on
THE ADMINISTRATION'S SPENDING REDUCTION PROPOSALS
before the
SENATE FINANCE COMMITTEE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
Dr. Richard W. Rahn
March 11, 1982

Mr. Chairman and members of this distinguished Committee: My name is Richard W. Rahn. I am Vice President and Chief Economist of the Chamber of Commerce of the United States. On behalf of our over 225,000 business, local and state chambers of commerce and association members, I welcome this opportunity to testify on the Administration's spending proposals for programs under this Committee's jurisdiction.

The U.S. Chamber recently reaffirmed its support for the President's program for Economic Recovery and endorsed those spending reductions proposed by the Administration on February 8, 1982. We believe, however, that outlay reductions beyond those proposed by the Administration must be made in order to reduce the deficit, preserve the Economic Recovery Tax Act and reverse the growth of the share of our gross national product accounted for by federal spending.

SUMMARY

- o We urge the Congress to enact as many program reductions as it takes to achieve the President's overall spending targets and to exempt no area form scrutiny for waste, fraud, abuse and unnecessary spending, including entitlements and defense.
- o We recommend an across-the-board freeze on all federal COLAs for one year in order to make substantial progress in reducing the deficit for FY 1983. A freeze is justified on the grounds of equity in fiscal restraint, equity with private sector wage and price concessions, and past overpayments in COLAs due to a seriously flawed CPI.
- o We strongly oppose legislation calling for any major tax increases. Bracket-creep and other factors alone will automatically increase taxes in FY '83 by an estimated $39 billion, according to OMB. That is more than enough to fund the increase in spending proposed by the President.

- We support the President's budgetary proposals for slowing the growth of entitlements. As we spell out in greater detail in our written statement we fully endorse the President's reforms for curbing the costs of Medicare, Medicaid, and unemployment compensation. In some instances such as Social Security and unemployment compensation, we offer recommendations on how additional budget savings may be achieved.
- We believe that the Social Security program is in dire financial straits and that action to improve the system must be taken this year. We offer a variety of modest benefit and accounting modifications that can yield sufficient savings to begin building an adequate reserve to meet most economic circumstances that we might face in the years ahead.
- We urge you to continue the process of reform of our unemployment insurance system begun in last year's budget process. We offer eight specific improvements ranging from better fraud and abuse efforts to tougher rules on repayment of outstanding loans.

1983 FEDERAL BUDGET ISSUES

Last year, the Congress and this Committee took dramatic action to reverse decades of rising taxes and excessive federal spending. Although the enacted spending cuts were unprecedented in their magnitude, it has since become apparent that they were insufficient when compared to the nearly intractable problem of controlling entitlement spending growth.

The FY 1982 spending level, originally proposed at $695 billion, has since slipped to an officially estimated $727 billion. Independent estimates, including that of the Congressional Budget Office, place FY 1982 spending at $740 billion. As a consequence, the projected deficit has ballooned from $48 billion to something in excess of $100 billion. Moreover, federal spending as a share of GNP, which reached a peacetime record of 23 percent in FY 1981, is now expected to rise to 23.5 percent in FY 1982. The financial market's response to these deficit projections has been one of concern and uncertainty. Real interest rates rose to record levels, contributing to the recession that now confronts us.

In his 1983 budget, the President has proposed outlay savings amounting to $43 billion. Although outlay reductions of this size and scope are well above what Congress is usually inclined to accept, the full enactment of all proposed savings would still leave the budget substantially unbalanced with an officially projected deficit of $91.5 billion for the fiscal year. Other independent analysts place the FY 1983 deficit much higher, and their projections for the out-years higher still.

In response to public concern over deficits of this magnitude, some in the Administration, the Congress and the private sector have begun to advocate policies that rely on tax increases to reduce the growing divergence between receipts and expenditures.

In our view, the enactment of such policies would be a grave mistake which would jeopardize the recovery and the well being of our citizens. The Economic Recovery Tax Act of 1981 is the foundation of a comprehensive set of policies to revitalize our economy and reverse many years of economic stagnation and limited growth in our standard of living. In response to our widely-acknowledged problems of low savings and investment, declining productivity growth, diminished international competitiveness, and severe structural problems in some of our core industries, the President proposed and Congress enacted a series of bold tax cuts to increase capital formation and work incentives.

Today, these same concerns are even more pressing than they were a year ago, and the problem is now compounded by a recession that spread faster and farther than any of us had anticipated a few months ago.

Under these circumstances, it would be counterproductive to enact tax increases or delay the already enacted tax cuts. To do so would simply weaken the economy, create greater business uncertainty and risk an even wider deficit as revenues are depressed and spending rises in response to increased unemployment. The Committee should note that the imminent recovery predicted by virtually all forecasters is predicated on the tax cuts becoming effective according to schedule.

Concern for deficits, while clearly justified, can be misguided when not related to the primary objective of the program for Economic Recovery -- reducing the share of our national income that accrues to government. Because this share has reached record levels, lowering it should be the major concern of public policymakers. How this share should be extracted from the private sector, whether through taxes or borrowing, distracts from our primary objective, and, indeed, may preclude our ever attaining it.

In effect, a tax increase this year would be an acknowledgement of our failure to control spending. We, at the Chamber, find this attitude to be dangerously premature. A large deficit provides a reluctant Congress and a cautious President with a powerful incentive to cut spending growth. Raising taxes would diminish this incentive and reduce the sense of fiscal urgency that will be required to make the tough choices on budget priorities.

Although we are opposed to deficit reducing measures that rely on tax increases, we are not indifferent to deficits of the magnitude now contemplated in the President's budget. We recognize, however, that these deficits are symptoms of deeper problems not directly related to any perceived revenue shortfall in the present. Rather, these deficits are a result of excess federal spending in the past and a failure to yet come to grips with entitlement programs that continue to grow at rates in excess of the Nation's ability to finance both them and other urgent national objectives.

Expressed this way, the appropriate policy response to our deficit problem is to seek further cuts in federal spending, with no area of the budget exempt from consideration. In part, our current budgetary dilemma stems from decisions made by the Administration, with Congress' concurrence, to exclude defense and Social Security spending from the budget reduction exercise. While such a decision may have been appropriate last year, such an exclusion is undesirable while the Nation is confronting what amounts to a fiscal emergency.

Including net interest expenses, nearly 60 percent of federal spending is or is designated as untouchable. It was the remaining 40 percent that took the bulk of the cuts in the FY 1982 budget and it is in this area where most of the FY 1983 outlay reductions are proposed. The continued reliance on these remaining programs for savings diminishes our ability to control federal spending in this and the subsequent fiscal years. Since these programs were the focus of most of the cuts last year, the opportunity for further signficant savings is reduced. Proponents of these programs feel that they have been unfairly singled out to bear the brunt of the cuts and will, thus, offer greater resistance to proposed reductions.

Last year, the sense of shared sacrifice was an important contributing factor to the successful enactment of the budget reductions. To the extent that this sense of shared sacrifice is compromised, the necessary cooperation may not be forthcoming. As a consequence, overreliance on only a portion of the spending programs could jeopardize efforts to make substantive progress in limiting budget growth.

While the Chamber has endorsed the President's outlay reductions for the

FY 1983 budget, we strongly encourage this Committee to seek further reductions in the spending programs under its jurisdiction. Specifically, we ask that this Committee give consideration to our proposed changes in Social Security, including a one-year freeze on the indexation of benefits, unemployment compensation, trade adjustment assistance and health care.

SOCIAL SECURITY

One Year Freeze on Cost of Living Adjustments

An analysis of the budget by function indicates that the two major sources of budget "uncontrollability" over the past dozen years have been in the areas of health and income security. Upon closer inspection of the income security programs, it is readily apparent that the automatic indexation provision of the transfer payments is by far the most important factor contributing to their recent rapid growth. The table on the next page details the effect of automatic indexation on the spending growth of five income security programs. While Medicare and Medicaid are not explicitly indexed by law, they are indexed in practice. The Congressional Budget Office refers to them as "quasi-indexed" programs.

Recognizing that indexation of federal spending has contributed to excessive growth in budget outlays, Congress has been considering a number of proposals to modify the indexation provisions or to de-index the programs altogether. Listed below are a number of the proposals along with estimated outlay savings for the next two fiscal years.

Budget Savings from Changes to Indexing Formula

Formula changes	Budget Outlay Savings $(Billions) FY 1983	Budget Outlay Savings $(Billions) FY 1984
1) full de-indexation (a freeze)	24	19
2) Administration's proposal*	0.6	1.3
3) 2/3 of CPI**	5.4	9.7
4) CPI minus 3%	9	9.5
5) 3 month delay in COLA payment **	2.8	3.4
6) the lesser of CPI or increase in average wages	3.4	0

* Formula change is for federal retirees only. Change from full CPI COLA to lesser of CPI or increase in General Schedule pay for Federal Employees.

** Congressional Budget Office proposal. For Social Security only.

Causes of Spending Uncontrollability

(Outlays, $ Billions)

	1979	1980	1981	1982	1983
Social Security					
Total Increase	8.3	10.4	14.5	20.9	16.7
Indexed portion	6.6	8.5	13.8	19.9	16.0
other factors	1.7	1.9	.7	1.0	.7
Civil Service Retirement					
Total Increase	1.2	1.7	2.3	2.3	1.8
Indexed portion	.5	.8	1.3	1.7	1.4
other factors	.7	.9	1.0	.6	.4
Military Retirement					
Total Increase	1.0	1.1	1.6	1.8	1.3
Indexed portion	.6	.7	1.2	1.4	1.2
other factors	.4	.4	.4	.4	.1
Railroad Retirement					
Total Increase	.3	.2	.5	.3	.2
Indexed portion	.2	.2	.4	.5	.6
other factors	.1	0	.1	-.2	-.4
Veterans Pensions					
Total Increase	.1	.3	.1	.2	.2
Indexed portion	0	0	.1	.2	.2
other factors	.1	.3	0	0	0

Source: Congressional Research Service
Chamber of Commerce of the United States

Beyond spending controllability, budget savings from federal COLAs are being considered for two other reasons -- first, to reduce the squeeze being placed on non-defense discretionary programs and second, to make a reduction in the deficit below the projected $92 billion in the President's budget. Non-defense discretionary program funding in the President's budget would be cut from $129.9 billion in FY '82 to $98.7 billion in FY '83. The funding in current dollar accounting would be a little below this level in the out-years. These proposed savings come after a heavy round of savings made in non-defense discretionary spending in the FY 1982 budget.

Given the size of the deficit for this and the next fiscal year, and the likelihood that the deficit may expand beyond these amounts in the out-years, the U.S. Chamber recommends that Congress enact the first of these proposals -- a one year, full de-indexation of all federal spending programs.

While it might seem easier to adopt one of the modified indexing formulas as a compromise, the political and economic consequences of this alternative would be, I believe, far worse than a one-year freeze on COLAs. These consequences are: 1) a staggering deficit; 2) a gross inequity in income growth between those who receive indexed federal entitlements and those who do not.

The economic rationale for reforming federal indexation provisions has been discussed in detail in the press and before a number of other committees of the Congress. Let me summarize the arguments. First, flaws in the Consumer Price Index as a measure of pure inflation caused excessive federal payments of $21 billion to recipients of indexed programs from 1978-1981. While a change in the homeownership component of the CPI has been made, it will correct only 50 percent of the distortion in the index as measured in the recent past and will not affect federal spending growth until FY 1986.

Second, full indexation to the CPI is highly inequitable with private sector indexing arrangements. Over 90 percent of the American working population has no COLA whatsoever. Of the small percentage which does have a formal COLA, the average protection is 58 percent of the CPI, not 100 percent of the CPI as with federal transfer payments. In recent years of double-digit inflation, this inequity has resulted in a massive transfer of income between generations and between those in the private sector and recipients of indexed federal benefits.

Third, economic problems in a number of industries have led to significant wage and COLA concessions in recent collective bargaining agreements. The United Food and Commercial Workers International Union has accepted a contract that freezes all wages and COLAs through 1983. A wage freeze and 25 percent COLA cut is in the process of ratification by the Teamsters. Unionized airline employees at Western Airlines have accepted a 10 percent cut in wages.

Without comparable action on indexed federal entitlement programs now, the inequities in income growth between the private sector and recipients of indexed benefits will become even wider.

While the economic rationale for a one-year de-indexation of federal spending programs is compelling, opponents of the proposal have argued that such a dramatic change would create substantial hardships for the recipients of Social Security benefits. The results of a comprehensive survey of sources of income for the retired population, conducted recently for President Carter's Commission on Pension Policy, show these fears to be unfounded.

According to the survey, 83 percent of all Social Security recipients reported at least one other source of income besides OASI benefits. The most typical recipient of Social Security income is a married couple, ages 65-74, whose income was $12,169 during the survey year, 1978. (This compares with a BLS definition of an intermediate budget for couples of $7846 for 1978). Over half of all married couples over 65 receiving Social Security have income from at least three sources. The needy, by any definition of poverty, comprise only a small fraction of Social Security recipients. Of the 17 percent of Social Security recipients who have no other source of income, the typical person is an unmarried or widowed woman over 75 with an average (1978) income of $2,621. This needy person represents only 4 percent of all Social Security recipients. These needy individuals have incomes considerably below an intermediate singles budget. To provide a reasonable standard of living for this group would require far more than full indexing to the CPI, and it is misleading to imply that fully indexed benefits are maintaining a decent standard of living for this small group of citizens.

The implication of the discussion for fully indexed benefits is clear. The vast majority of retired persons whose Social Security benefits are fully indexed to the CPI have adequate incomes, and have no economic need for being over-compensated for inflation. A one-year freeze on indexing would about compensate for past overpayments due to flaws in the CPI and help offset the massive transfers of income between segments of our population that have occurred over the past several years. Since 1974, automatic indexation of Social Security payments has allowed these benefits to increase 28 percent faster than average spendable weekly earnings.

During this freeze period, a better indexing formula than the CPI should be found. This should be a top priority of the President's bipartisan commission on Social Security reform. Failing this, Congress should consider going back to a system of discretionary adjustments after the end of the freeze. Among the most attractive proposals is the "Domenici Proposal" -- CPI minus 3 percent, and the CBO proposal -- 2/3 of CPI, both of which come close to equity with private sector COLA protection.

Necessary, Long-Run Structural Reforms in Social Security

Social Security is our largest and most important domestic program. It comprises almost one quarter of the entire federal budget. The program directly touches the lives of the vast majority of Americans. It provides a floor of protection for 9 out of every 10 workers and pays monthly benefits to about one out of every six persons in the United States. It is also a program that is on the verge of insolvency. According to the latest figures released by the Social Security Administration and predicting the maximum amount of interfund borrowing authorized under P.L. 97-123, the Old Age and Survivors Trust Fund will have insufficient funds to pay benefits in July of 1983. We are disappointed that the many vital decisions necessary to avoid this disaster must be delayed pending the report of the National Commission on Social Security Reform which will not be forthcoming until the end of this year. While we regret that this means of addressing the issue was found to be necessary, we do support the work of the Commission and its effort to preserve the financial integrity of the Social Security program.

In addition to the automatic indexation of program benefits to the CPI, there are six other aspects of the program indexed to increases in average wages. They are:

- the index factors used in the benefit formula to compute the benefits for workers first becoming eligible;
- the decoupled benefit formula "bend points";
- the maximum family benefit formula "bend points";
- the Social Security "wage base" (i.e., maximum annual amount of earnings considered for both taxation and benefit computation purposes);
- the "retirement test" annual exempt amount (i.e., maximum earnings which a person may receive without suffering benefit reduction);
- the earnings base necessary to be credited with one quarter of coverage.

Of these six areas the first three have the effect of increasing initial benefits, the fourth increases taxes to help finance those benefits, the next allows beneficiaries to keep more of their earnings and the last one has very little financial effect at all.

The one year freeze we advocate would affect only the benefits themselves and not any of these other built in escalators. These factors, in addition to the fact that many more beneficiaries will be added to the Social Security rolls in the coming year, assure that the program will still experience dramatic growth even with a COLA freeze.

In addition to COLA reform, we would urge the National Commission and Congress to fully consider several aspects of the Social Security program and make changes which will promote the financial integrity of the program. They should include:

(1) Mandate Universal coverage It is necessary to require coverage of all federal employees and those state and local government employees not now participating in Social Security. This step would provide a temporary windfall to the trust funds at a time when added revenues are desperately needed to avoid insolvency. Moreover, it would end the withdrawals from Social Security by state and local governments which are eroding the tax base of Social Security and further threatening its solvency.

Ninety percent of the American workforce is covered by Social Security, but about 7,000,000 workers, mostly federal, state and local government employees, are not. Nonetheless, about 80% of the uncovered employees finally qualify for Social Security benefits as a result of working in covered employment at some time in their career or qualifying as a dependent.

If mandatory universal coverage were effective January 1983, over $100 billion in additional revenues could be expected by 1988. We do not propose raiding the retirement trust funds for federal, state and local government employees. Those funds belong to these employees and must be used exclusively to pay promised pensions to both present and future beneficiaries. We do propose, however, that all working Americans have Social Security as their base line pension. Employer-provided pensions, where available, should be supplemental to, and integrated with, Social Security just as they are now in the majority of private and public sector pensions.

(2) Raise the retirement age and discourage early retirement. We support proposals made to raise the age of entitlement for Social Security benefits to 68 with actuarial reductions for retirement before that age. For example, a 62-year-old would be eligible for a benefit equal to perhaps 64% of the full benefit at age 68 rather than the 80% at age 65 that is now available. We support these proposals for two basic reasons. First, people are living longer and healthier lives today, and the retirement age under Social Security should reflect that fact. Also, this proposal would go a long way toward solving the long-term financial problems projected for Social Security

Any increase in the retirement age would have to be phased in gradually over a period of several years. We would suggest beginning the phase-in during 1990 with the age 68 retirement age fully in place by the year 2000. This is a process which must be started as early as possible in order to prepare individuals for this major change.

(3) Enact certain proposals suggested by the Reagan Administration last year. The Chamber fully supports the proposals outlined by the Administration in May of 1981 to:

(A) Change Benefit Computation Point from Age 62 to 65.

The benefit formula treats early retirement the same as waiting until age 65. After 65, there is an annual incentive to continue working. Early retirees at 62 get 80% of what they would get at 65. This proposal would discourage early retirement by assigning zero value to the age 62-64 period, thus reducing benefits in such cases while rewarding those who elect to work until age 65. This returns the program to the formula used before the age of retirement for women was lowered to 62 in 1956.

(B) Require "Medical Only" Determination of Disability

Workers can now qualify for disability benefits on combinations of medical and non-medical factors, such as age, education and work experience. More than one-third of disability cases age 60 to 65 involve non-medical factors. This proposal would limit qualification to medical factors alone, thus restoring program to original purposes.

(C) Increase Waiting Period to Six Months for Disability Benefits.

Under a 1972 liberalization of the program, the waiting period for disability benefits was reduced from six to five months on the assumption that ample funds would be available. This proposal would restore the six-month waiting period and conforms to most private disability insurance programs.

(D) Require Prognosis of 24-plus Months of Disability

Workers now seeking disability benefits must show only that disability claimed will exceed 12 months or will result in death. The 12-month test, enacted in 1965, replaced a test of "long-continued and indefinite duration" in prior law.This proposal would restore the original intent of the law, requiring that the prognosis of disability be of long duration, at least 24 months, a more reasonable definition of disability.

(E) Increase Requirement for Insured Status to 30 Quarters.

Workers may now qualify for disability benefits even if they have been in the work force only 20 out of the past 40 quarters. Therefore a person could be out of covered employment for 5 years and still qualify This proposal would set the minimum at 30 out of the past 40 quarters, thus more closely tying benefits to the principle that they are replacement for wages recently lost.

(F) Eliminate Children's Benefits in Early-Retirement Cases.

Children under 18 (or under 22, if in school) are now eligible for benefits on the basis of a retired parent's wage record. Thus a retiree with a child receives a dependent's benefit, whereas a retiree with no children gets only his own benefit This proposal would end this inequity in early-retirement cases, encouraging the worker to continue work until 65.

(G) Extend Disability Maximum Family Benefit to Retirement and Survivors Cases.

Benefits for families of retired and deceased workers can now actually exceed that worker's net take-home pay. The proposal would extend the maximum limitation on benefits to families in disability cases enacted in 1980 to retirement and survivor cases. This would return the program closer to its original purpose as a "floor" of protection.

(H) Increase Bend Points by 50% Instead of 100% of Wage Increases for 1982-87.

In 1977, the "bend points" (dollar amounts referred to in the weighted benefit formula) were made subject to automatic wage indexing. This legislated change intended, in part, to offset the cost impact of earlier legislation and the faulty benefit computation procedure adopted in the 1972 amendments. However, benefit levels today remain disproportionately high (by about 10 percent) compared with the pre-1972 levels. This proposal would restore the traditional relative benefit levels for future beneficiaries by increasing the "bend points" by 50% (instead of 100%) of increases in average wage earnings for the years 1982-87, after which the 100% factor would be restored to the formula.

All the foregoing proposals are consistent with our conviction that the growth of Social Security's cost must be contained if we are to solve its serious financial problems. These proposals are well thought out and would contain that growth in costs in a manner not inconsistent with the goals and responsibilities of Social Security. They are designed to reduce the adverse effects upon the system of past liberalizations and should be enacted.

Although the Chamber has traditionally supported payroll tax increases to meet benefit obligations, we do not recommend this course of action because of the adverse economic effect that a payroll tax increase would have and its inconsistency with the President's economic recovery program.

We remain fundamentally opposed to general revenue financing in any form. We would oppose both direct infusions from the Treasury, including loans, and indirect methods such as income tax credits or deductions.

UNEMPLOYMENT COMPENSATION

We strongly support the Administration's budget proposals governing the unemployment compensation (UC) program. We also urge the enactment of additional reforms that will reduce the cost of unemployment benefits, improve the financing of program administration, and strengthen incentives for responsible financing of benefits. These measures will also result in federal budget savings.

Administration's Major Themes

Although 97% of American workers are covered by the regular UC program, a number also are eligible for supplementary benefits under approximately 20 separate federal programs serving limited constituencies. These special programs typically pay higher weekly benefits, and for a longer duration, than regular UC. Experience with the special programs reveals that the added benefits are superfluous at best and, at worst, prolong the duration of unemployment.

o The largest and best known special program is Trade Adjustment Assistance (TAA). Trade benefits are available for claimants laid off from jobs in industries certified to be in decline because of foreign competition.

The Omnibus Budget Reconciliation Act of 1981 included a comprehensive reform of TAA unemployment benefits, but even after those reforms, TAA provides from 13 to 26 weeks of extra unemployment compensation solely because the job loss was caused by a foreign rather than a domestic competitor. These extra weeks of compenstion are not only inequitable, but provide disincentives for claimants to seek new employment.

Advocates of TAA have argued that it is essential to secure public support for free trade policies. That may have been true when TAA was first implemented because regular UC benefits were much more limited than today. Since the mid-60's, however, UC benefits are available for at least 6 months during periods of economic expansion, and are automatically extended to 9 months when unemployment levels go up. Benefits have been raised--a record $23 billion is the projected payout in 1982--and eligibility has been considerably loosened. Coverage has expanded to include 97% of the workforce.

The Administration proposes to phase out the extra weeks of TAA benefits. Under this proposal, eligibility, amount, and duration of benefits for all claimants will be determined according to the regular federal-state unemployment-insurance system. The proposal eliminates the inequity in the current law and reduces the incentives for TAA claimants to delay taking new jobs.

o Another program whose abuses have been well-documented is the Redwood Employee Protection Plan (REPP), created in 1978 to assist loggers whose jobs were eliminated when Congress established the Redwood National Park. REPP provides weekly cash benefits that supplement regular UC--bringing combined benefits up to the amount of pre-lay-off wages--as well as retraining and relocation allowances and other benefits. Claimants receiving UC and REPP benefits have little incentive to find new jobs.

The Administration proposes to limit REPP benefits to workers unemployed on or before December 31, 1981. Additional savings, however, could be achieved by phasing out REPP entirely instead of continuing lifetime income support for the able-bodied.

o Railroad Unemployment Insurance (RRUI) is a program administered by the railroad retirement board independent of the regular federal-state unemployment insurance system. Benefits replace 60% of base-year wages, up to $125 a week, and last 26 weeks (extended by as much as 26 additional weeks depending on length of employment and the unemployment rate for the nation or the railroad industry).

The Administration proposes to place rail workers under the regular UC program as part of a phase out of the RRUI. Elimination of RRUI will result in higher unemployment benefits for most railroad employees, since weekly maximums in most states are well in excess of the current railroad unemployment insurance maximum. Nevertheless, these cost increases will be more than offset by savings from eliminating the remainder of the railroad retirement system.

Further Reform in the Unemployment Compensation Program

The over-riding problem in the UC program is the impending insolvency of the Unemployment Trust Fund. Eighteen jurisdictions have depleted their reserves, and the federal government has advanced funds out of general revenues in order to continue paying benefits. These advances totalled nearly $7 billion as of January. Additional advances of general revenues to the Extended Unemployment Compensation Account (EUCA) total $6 billion. Further advances to the states and EUCA are expected. Combined with the existing indebtedness, advances to the Trust Fund from federal general revenues are projected to total nearly $17 billion for FY 1982. At that point, the Trust Fund will be technically bankrupt.

A number of the borrowing jurisdictions have never repaid advances received during the 1974-75 recession and are now in default, triggering an automatic increase in the Federal Unemployment Tax. That tax increase applies equally to all employers in a defaulting state, regardless of their individual claims records.

The Omnibus Budget Reconciliation Act of 1981 accomplished a number of important reforms in the UC program, and also placed a cap on the Federal Unemployment Tax increase for employers in defaulting states that take steps to restore solvency.

A number of additional reforms should be legislated to reduce costs, eliminate benefit inequities, and restore incentives for responsible financing. These include the following:

1. Unified budget. Remove the Unemployment Trust Fund from the unified federal budget. At present states control outlays and income because they determine benefit amount and eligibility as well as employer tax rates. State-collected taxes, however, are held by the U.S. Treasury, and states do not include UC funds in their budgets. Removal of the Trust Fund from the federal budget and requiring states to include their UC accounts in their own budgets would give them greater incentive to insure that benefits are fully financed.

2. Partial Repayment of Loans. Permit defaulting states to make partial repayment of their debt by allowing them to repay from their trust account the equivalent of the amount raised by the incremental FUTA increase. At present a state may avoid default only by repaying its entire debt. If a state cannot raise the full amount (for example during an economic downturn when a large tax increase is inadvisable), it has no incentive to voluntarily repay a smaller amount because there will be an automatic FUTA increase anyway. If a state could avoid the FUTA increase by repaying the equivalent amount out of funds in its trust account, there would be an incentive to raise the funds voluntarily. This would allow the state to experience rate the tax increase, more fairly allocating benefit costs to responsible employers.

3. Labor disputes. Some states actually allow workers who strike to collect unemployment benefits, forcing employers to subsidize the strike. Even in states whose laws appear to prohibit strikers' benefits, courts have created loopholes allowing strikers to draw benefits. It is up to states to enact legislation closing such loopholes, but the federal government should prohibit extended benefits for claimants who are out of work because of a labor dispute.

4. Benefit extensions. Under current law, states are required to pay extended benefits while the unemployment rate is above a set level, even though that rate is normal for that state's economy. For example, Alaska and Puerto Rico, which have high insured unemployment rates relative to other jurisdictions, have paid extended benefits

continuously since 1975! States should be given the option to set their triggers for extended benefits at higher rates but those triggers should lapse after two years unless there has been a 20 percent increase in unemployment.

5. Work incentives. Claimants seeking extended benefits need additional work incentives to combat work disincentives created by the benefit extension.

States are required to pay extended benefits at the same rate as the last week of regular unemployment benefits. Federal law should limit the amount of extended benefits to 75 percent of the amount payable for the last week of regular benefits to provide greater incentive to take jobs, and no claimant should receive extended benefits that, together with regular benefits, total more than 75% of base period wages.

6. Administration costs. Congress recently approved a supplemental appropriation requested by the Administration to provide funds to adminster UC claims and run the state Employment Service. Both functions are handled by the state employment security agencies, and are financed by grants of Federal Unemployment Tax revenues to the state governments. A supplemental appropriation was required becausethere were insufficient revenues in the Trust Fund. Future deficits in administrative funds, however, could be reduced by requiring federal and state agencies and non-profit employers to contribute to the cost of claims administration and to pay the full costs of benefits.

At present, public-sector and non-profit employers must reimburse the cost of benefits paid to their employees, but business must pick up the tab for administering such claims. In some states, reimbursable employers are not even required to pay the full cost of benefits claimed by their employees, exacerbating financial strains on the Trust Fund.

7. Job finding. A substantial savings could be accomplished by requiring all extended benefits claimants to participate in a program, to be run by the Employment Service, teaching claimants how to look for jobs. Not only would fewer weeks of benefits be payable as claimants

find work, with an additional reduction in the administrative work load, but those applicants who are not seriously looking for work--or already holding jobs in the "underground economy"--would be disqualified.

8. Fraud and abuse. A recent federal study found that the true rate of improper payments was double the rate reported in the most accurate city and 40 times higher in the least accurate. We estimate that improper payments are costing the UC program $3 to $4 billion a year. Reducing that amount by enforcing existing law would result in significant savings.

HEALTH CARE

The President has proposed a budget of $78 billion for health in FY 1983, $4.7 billion more than in FY 82. About 93 percent of federal outlays for health are for Medicare and Medicaid, including the proposed $3 billion in reductions. Among other areas scheduled for reductions are the Professional Standards Review Organizations, health planning, and health maintenance organizations. We support all the proposed reductions.

Medicare

Medicare, Title XVIII of the Social Security Act, was implemented in 1966. In its first year, it cost about $3 billion. Although this seems to be a mere pittance compared to today's health care cost, even this expenditure was a great deal more than Medicare advocates predicted.

Today, Medicare has grown into a $45 billion program serving not only persons 65 years of age and older but, in some cases, certain disabled persons, for a total beneficiary population of nearly 30 million. An estimated 500,000 of these are workers aged 65-69, according to the U.S. Department of Labor.

The financing of health services for employees and their families should be primarily by employer and employee contributions. This conviction, coupled with the Chamber's support for the Administration's basic economic goals, allows us to endorse the measure to have employer-paid insurance be the first payor of claims for working persons aged 65 to 69, with Medicare becoming the secondary or supplemental program.

According to several estimates, this reversal of current health care liability should cost employers an additional $300 million. However, the Chamber and bulk of its members recognize that business must do its fair share in helping to reduce the size of federal government and revitalize the economy. This Medicare reform is one way that business can contribute to this laudable goal.

We realize, of course, that this $300 million employer cost could increase quickly as older workers, who consume health services at two to three times the rate of younger persons, cause an employer's claims experience and subsequent premiums to rise.

Naturally, we are concerned that this provision will continue the trend by government to save money on public health programs at the expense of the private sector. This can occur in ways that are not always so obvious and which are most acute in payments for health care services.

For example, a recent publication by the Health Insurance Association of America reported that because of reimbursement cuts by Medicare and Medicaid, almost $5 billion in 1981 were passed on to other patients, those insured by commercial plans and those paying directly out of pocket. Medicare cost saving recommendations in the President's budget could have the same result. With this in mind, our positions on other selected Medicare reform provisions in the Administration's budget follow.

1. Indexing Medicare Part B Deductible. An estimated $65 million would be saved in FY '83 if the Supplemental Medical Insurance (Part B) of Medicare were indexed to the Consumer Price Index in order to keep its economic value constant. This deductible, which acts partly as a deterrent to over-utilization, is now $75 per person per year. The Chamber supports this cost saving provision of the budget.

2. Eligibility to Start During First Full Month After Age 65. An estimated $145 million would be saved in FY '83 if this provision were enacted. The Chamber supports this and similar changes proposed for other entitlement programs.

3. Establish Part A Entitlement Coverage for Federal Workers. The Chamber has long called for universal Social Security coverage. This provision would be a first step in that direction. By bringing federal employees into Medicare's Hospital Insurance (HI) (Part A), the program would realize a $619 million revenue increase in 1983. It is vital that this provision be enacted, since HI Trust Fund expenditures will exceed income in FY 1985 and will be exhausted by the early 1990s.

4. Institute Co-Payments for Home Health Services. Another cost-saving feature of the budget which we support, this proposal is also designed to reduce over-utilization by imposing a 5 percent co-payment for the first 100 home health visits and a 20 percent co-payment thereafter. Medicare would save about $35 million in FY '83 under this change. Left unchecked, this service--which is growing at an annual rate of 30 percent--would accelerate the depletion of the HI trust fund.

5. Reduce Rate of Increase of Hospital Reimbursement by Two Percent. A savings of $653 million is projected for FY '83 if this provision were enacted. It is designed to offset hospital increases that average 20 percent nationwide, well over double the general rate of inflation for 1981. However, many hospitals are already complaining that Medicare is paying for only about 60 percent of their costs, "requiring" them to pass on these "losses" to other payors. In 1981, this shortfall amounted to nearly $5 billion. Accordingly, such savings amount to cost shifting. Clearly, more systemic changes need to be instituted to result in real overall savings. One such method is prospective payments in which charges are established between providers and payors in advance. Hospitals then have the incentive to meet those targets, realizing the savings if they come under the target and being at risk if they are over. Such a payment system would be consistent with the Administration's plans to develop a more competitive health care system as well as its proposed payment system for renal dialyses provided to Medicare beneficiaries.

Medicaid

Medicaid cutbacks would save $2 billion in FY '83. We also support the various Medicaid reforms proposed by the Administration in the FY '83 budget. These include our support for modest cost sharing by Medicaid recipients for a total savings of $329 million. Additional reforms to Medicaid are included in the Administration's proposal for a New Federalism under the proposed plan, the federal government in FY '84 would assume complete responsibility for Medicaid, in exchange for transfering to the States control of the Aid to Families with Dependent Children and food stamps programs. The Chamber supports the New Federalism concept and is awaiting more details and the specific Administration bill.

Professional Standards Review Organizations (PSROs)

PSROs promised to save money in Medicare by employing physician peer review groups to monitor and evaluate the hospital care of Medicare and other public health patients. Nearly 200 PSROs have been operating at various levels of effectiveness for nearly 10 years. Yet, every independent assessment of these programs reveals that PSROs are spending more than they are saving. And, in some cases, savings have been made at the expense of the private sector. Yet, about 15 percent of the PSROs have achieved a positive cost-benefit record. For this reason, private industry has contracted with about 25 PSROs to conduct private review on 50 private patient populations.

As we testified last year, we support the phase out of federal funds for PSROs, which will save the government $76 million in FY '83 outlays. However, consistent with our earlier recommendations, we are pleased to learn that Senator David Durenberger and others are considering introducing legislation to help create private peer review groups that would contract with the federal government or any other interested organization for their services. Certainly, a watchdog is needed on the care provided to elderly and poor patients to eliminate fraud, abuse and waste. Private PSROs, under a contractual arrangement -- not government subsidy -- hold the promise to provide this necessary service.

Health Planning

The President's budget also calls for phasing out federally funded health planning, for a FY '83 savings of $67 million. The Chamber supports this proposal to remove the federal government from an activity which should be supported and conducted at the local and state level, to assure that local problems are treated with local solutions, not Washington-based edicts.

In many cases, over 200 federally funded health planning agencies have concentrated their efforts on preventing hospitals from expanding their capacity and generally locking in existing health care providers while denying market entry to other alternative delivery systems. Such a program is counter to the Administration-endorsed and Chamber-backed goal of creating a more competitive health care system.

Although not established to replace local health planning bodies, business coalitions on health in about 50 communities are recommending to their private sector counterparts in the health industry a variety of voluntary methods they can use to contain rising health care costs. We feel that these kinds of private, cooperative efforts hold the best hope of containing rising health care costs, without relying on government intervention.

Health Maintenance Organizations

Also scheduled to be phased out by FY '84 are federal funds for health maintenance organizations (HMOs), which are prepaid, multi-specialty group medical practices. This phase out would save the federal government an additional $7 million by FY '83.

Since the federal program of grants and loans for HMOs began about a decade ago, 250 HMOs have been created with a total enrollment of over 10 million.

The federal program was initiated as an experiment, and, for the most part, the experiment has been successful and should be terminated. Continued federal support for HMOs would result in prolonged subsidies and in unfair competition to non-federally funded HMOs and other forms of health care delivery, including fee-for-practice, solo practitioners. The emergence of HMOs has instilled some long needed competition into the health care system. This competition should continue without federal financial aid, as more private capital is infused into these alternative health care delivery systems. We note that many health insurance companies are investing substantial sums into such enterprises.

The President's FY 1983 budget for health represents a continued trend in the right direction to reduce the federal role in health care and return more control to state and local governments and to private operations. Considerable sums of money can be saved by adopting this course of action. Such a strategy will also make our pluralistic health care system more responsive to local needs and resources.

We recognize that some of the reforms in the President's budget require employers to make certain sacrifices, including Medicare becoming the secondary payor of health claims for the working elderly. However, business is prepared to do its part.

We also are prepared to call attention to those strategies that appear to be saving money but, in reality, are shifting costs from the government to the private sector. However, we must contain our rising national health care bill, now pegged at about $300 billion annually. The President's budget is another step in the right direction to achieve this objective.

The Chairman. We will meet again tomorrow morning at 10 a.m.

[Whereupon, at 12:07 p.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

TESTIMONY ON MATERNAL AND CHILD HEALTH SERVICES (WOMEN, INFANTS AND CHILDREN) BLOCK GRANT

Michigan Department of Public Health
Bailus Walker, Ph.D., Director
March 11, 1982

The Michigan Department of Public Health strongly supports the full authorization level of funding for the Maternal and Child Health Services Block Grant. The Department strongly opposes incorporation of the Special Supplemental Food Program for Women, Infants, and Children (WIC Program) within the block grant. The Department urges a moratorium on any additional changes in the Maternal and Child Health Services Block Grant.

The Maternal and Child Health Services Block Grant (as designed in 1981-82) supports critical programs which assure service accessibility to those in need and contributes to reducing infant mortality and the incidence of preventable diseases and handicapping conditions. Continuation funding for these MCH programs is essential to meeting a minimum level of need. Preferably, funding should approximate at least the 1981-82 authorization level for the block grant. This would allow a service capacity which more closely approximates the needs identified for prenatal care, child health care, services for handicapped children, etc.

Incorporation of the WIC program into the MCH Block Grant, coupled with the drastic reduction in funding, would reduce the level of investment in our children, at the expense of a program which has proven to be effective. If budget cuts are made at the federal level, it cannot be assumed (especially in Michigan) that state funds would be made available to make up for the lost federal funds. In addition, the current matching requirements in the MCH Block Grant, if applied to the expanded MCH-WIC Block Grant, may present serious problems to many states.

The desirability for coordination between the MCH programs and the WIC program is well accepted and a reality in this state. Bringing these two efforts into one block grant, with the accompanying funding reductions, will force competition rather than coordination. Neither MCH nor WIC should be reduced at the expense of the other. Coordination can and should be brought about without having to create an expanded block grant.

MDPH/PHS
3/10/82

STATEMENT OF DANIEL K. O'CONNELL
BEFORE THE
SENATE FINANCE COMMITTEE

Mr. Chairman, I am Daniel K. O'Connell, Executive Vice President - Corporate Affairs of Ryder System, Inc. Ryder is engaged principally in truck leasing and renting, specialized highway transportation and truckstop operations. We wish to bring to the Committee's attention certain concerns and suggestions we have relating to the structure of the proposed alternative minimum tax on corporations.

The following statement is contained in the Treasury Department's February 26, 1982, "General and Technical Explanations of Tax Revisions":

> "The amount of any credit or net operating loss carryover or carryback allowable in computing the regular corporate tax will be deemed to be absorbed, even in years in which the corporation pays the corporate minimum tax instead of the regular tax.
>
> However, in order to prevent a loss of tax benefits from credits, NOL carryovers, or any other deductions used in calculating the regular tax, a minimum tax credit will be created. This minimum tax credit will equal the excess of the corporate minimum tax liability in any year over the amount of regular corporate income tax calculated for that year. The minimum tax credit will apply after all other credits available against the regular tax have been exhausted. The minimum tax credit may be carried over for up to fifteen years.

Our chief concern arises from the sentence: "The minimum tax credit will apply after all other credits available against the regular tax have been exhausted." Since 1976, the Internal Revenue Code has permitted taxpayers to use investment tax credits (ITCs) on a first-in, first-out (FIFO) basis. This allows a taxpayer that generates ITC carryforwards, to roll them forward in time, as the older credit carryforwards are used and are replaced by new credit carryforwards. The FIFO method of carryforward application greatly lessened the danger that any credit will expire before the taxpayer has an opportunity to use it. The danger of expiration has been further lessened by the 1981 provisions extending the ITC carryforward period from 7 years to 15 years.

Although the Treasury proposal provides a 15-year carryforward for unused minimum tax credits (MTCs), it does not appear to provide the FIFO treatment accorded ITCs. The alternative minimum tax proposed by the Treasury Department will result in ITCs being converted to MTCs to the extent ITCs are used to reduce regular tax below the alternative minimum tax.

EXAMPLE I

Regular Tax	
Taxable Income	$100
Regular Tax before Credits at 46%	46
Less ITC	(36)
Regular Tax	$ 10
Minimum Tax	
Taxable Income	$100
Preference Income	20
Minimum Tax Base	120
Minimum Tax at 15%	18
MTC Generated	$ 8

In Example I, $8 of the $36 of ITC applied was converted, in effect, into an MTC of $8. If MTCs so generated must be accumulated and not used until all available ITCs are exhausted (as the Treasury Explanation appears to provide), then substantial amounts of MTC may well expire before they can be applied. This is so because many taxpayers are constantly replenishing and increasing their aggregate ITC carryforwards with newly generated ITCs. The generating of these new ITCs becomes a bar to the eventual use of the MTCs which were created to replace ITCs for which the taxpayer received no benefit. This problem will be particularly acute for corporations which already had accumulated large ITC carryforwards prior to 1982.

We understand that the purpose of the proposed alternative minimum tax on corporations is to defer the use of tax benefits and thereby assure certain revenue flows to the Treasury. It is not the purpose of the proposal to cause the forfeiture of benefits or to increase the likelihood of forfeiture. It would be ironic indeed if forfeitures of MTCs were the result of the taxpayer generating new ITCs by making qualified investments in response to the investment incentives of the Internal Revenue Code.

The potential forfeiture problem we have described here can be avoided simply, by treating MTC carryforwards in the same manner as ITC carryforwards. MTCs would be aged, just as ITCs are; and the MTC generated in a particular year would be used, on a FIFO basis, immediately after the ITC generated in the same year.

EXAMPLE II

Regular Tax	1988	1989
Taxable Income	$100	$110
Regular Tax before Credits (46%)	46	48.3
ITC - Vintage 1984	(32)	
MTC - Vintage 1984	(9.4)	(3.6)
ITC - Vintage 1985		(33.0)
MTC - Vintage 1985		(6.9)
Regular Tax	$ 4.6	$ 4.8

Example II illustrates how aged MTCs could be applied along with aged ITCs, on a FIFO basis, to prevent the forfeiture of benefits. The taxpayer in the example had ITC carryforwards of $32 from 1984 and $33 from 1985; and MTC carryforwards of $13 from 1984 and $13.50 from 1985. Note that, in the example, we applied credits to offset only 90% of regular tax liability. As a result, $6.60 of the 1985-vintage MTC carryforward is available for use in 1990 before application of 1986 ITC carryforwards.

Although the question was not treated in the Treasury explanation, it will be important to clarify whether the 90% limitation on the use of ITCs applies to MTCs as well. The answer will affect the calculation of regular tax and the aging and expiration of MTCs.

Since we believe none of the revenue projections for the alternative minimum tax are based on increased forfeiture of benefits, our proposal to age and apply MTC carryforwards in a way similar to ITC carryforwards will have no adverse affect on those revenue projections.

TESTIMONY
OF THE
COMMUNITY SERVICE SOCIETY OF NEW YORK

The Community Service Society of New York (CSS) is pleased to have this opportunity to express its views on what we feel would be destructive cutbacks in two of this nation's most critical survival programs: Aid to Families with Dependent Children (AFDC) and Medicaid. CSS is one of the oldest non-profit, nonsectarian social agencies in the United States. For well over a century, we have pioneered in developing services and advocating social policies which have aided successive generations of the poor and disadvantaged. While our primary focus is on the poor in New York City, many of the innovations and concerns developed by our agency have been adopted nationwide. Recently, our concerns and energies have been absorbed by the effects of federal budget cuts in human services and the cascading impacts which these radical alterations have forced upon our city and state and upon the millions of poor people, the vast majority of whom are children, who have been the primary victims of Reaganomics.

The Administration's FY 83 budget proposals for the Aid to Families with Dependent Children (AFDC) and Medicaid programs, both of which fall within the jurisdiction of the Senate Finance Committee, demonstrate a refusal on the Administration's part to acknowledge either how these programs work or whom they serve. CSS questions the Administration's understanding of poverty as it exists in America today. AFDC and Medicaid recipients are poor. Many of them are very young or very old. Some are mothers of small children. Others are disabled—physically, mentally or emotionally. Still others cannot find or handle jobs which pay enough to maintain their families without further assistance, even at minimal living standards. These are not defrauders, wastrels, or abusers. They are people who, in contrast to the majority, have had less luck, less ability or less opportunity to make ends meet.

The AFDC program provides income for 3.8 million poor families in the United States with 7.6 million children dependent upon the benefits for part or all of their support. The AFDC program in New York State, prior to implementation of the FY 82 budget legislation, helped to support 373,000 poor families, including 767,000 children. About 50,000 of these families have had their benefits reduced or eliminated in the current fiscal year. These are, in almost all cases, families with working mothers who have work incomes above the limit set by federal statute last year (150 percent of the state standard of need) or who have been affected by the cap on allowable work expenses and the four-month limitation on work incentives. The health and medical needs of AFDC families, as well as the health and medical needs of 4.0 million aged, blind and/or disabled poor persons and of certain additional categories of medically needy poor persons who are not receiving public assistance are met primarily through the Medicaid program. In New York State, 2 million people rely upon Medicaid for their necessary medical care. The state can ill afford to make up for the loss in federal dollars from the FY 82 cuts. Loss of services is bound to result if further cuts are made in the FY 83 Medicaid budget.

While the AFDC and Medicaid programs have many problems, these will not be solved by the approach taken by the Administration in its budget proposals. A realistic approach would deal with uncovering the gaps between the level of income and health services needed to sustain a decent living standard and the availability of such income and services to the nation's poor. Under such an approach, employment would not be assumed to a viable alternative for a single mother where neither jobs nor childcare exist. Mandated workfare, as proposed by the Administration, would force mothers to leave small children under questionable child care arrangements while providing them with neither real work experience nor financial gain. Low income home energy assistance, specifically enacted by Congress to fill a perceived gap, should not subsequently and arbitrarily be termed duplicative by the Administration, especially in light of the continued inflation and static public assistance benefits of the past few years. In New York State, for example, the basic public assistance grant remained unchanged from 1974 until 1981, during which time the area's cost of living rose by 70 percent and utility costs by as much as 136 percent. Although a 15 percent grant increase was enacted in 1981, a sizable gap remains between available benefits and actual needs, even with the help of federal energy assistance.

Rounding benefits down to the lower whole dollar, another Administration proposal, would mean that people would not even receive the amount of money to which they are actually entitled and would reduce the income of all recipient families. Since similar rounding down proposals have been made for the food stamp and Supplemental Security Income programs, a poor family would face the likelihood of two (and the possibility of three) separate monthly benefit reductions. Proposals to mandate job search for AFDC applicants and to eliminate military service by the father as a reason for AFDC eligibility would delay or deny aid to children even though the need for the aid would not be in question. Requiring applicants to look for a job (in families where there are no small children) and putting more effort into finding absent servicemen who could support their families are not unreasonable proposals. What is unreasonable is the withholding of aid to these families while the search for job or father is being conducted.

One of the ways the Administration proposes to cut Medicaid expenditures for FY 83 is to require beneficiaries to contribute to the cost of their health care. Copayments cause people to ignore preventive and follow-up care and to delay seeking medical attention until their health problems have worsened. Not only does requiring patient contributions cause severe hardship for Medicaid recipients, but it also means that hospitals which serve the poor face an increasing financial burden because of people who cannot pay for their health care. The administrative costs involved in collecting copayments often exceed the monies recouped. Instead of whittling away on eligibility and benefits for program recipients, Medicaid should be dealt with in the context of the overall problem of escalating costs in the health care industry. A strong federal posture is needed to encourage states to establish rate control systems and to divert patients away from costly institutional care to care in less expensive but appropriate settings. Home care, preventive and primary care, and ambulatory surgery are examples of proven cost-effective alternatives to hospital and nursing home care.

The Administration is proposing to make further cuts in social programs such as AFDC and Medicaid at a time when every available social indicator reveals that the need for them is increasing. Census Bureau data indicate that poverty is on the rise: from 1979 to 1980 the percentage of the population that is poor rose from 11.6 percent to 13 percent. Department of Labor unemployment rates have spiraled upwards: the jobless rate of 8.8 percent in February 1982 was the second highest since the beginning of World War II. The Consumer Price Index shows that inflation, while it has slowed down, has not ceased: the cost of living for the New York Area rose 8.3

percent for the year ending December 1981. Nevertheless, the Administration persists in seeking a solution to the problems of the nation by reducing benefits to the poor and the sick, to helpless children and impoverished aged.

There can be little doubt any longer that the poor and powerless have borne the brunt of the Administration's economic programs. We urge that this punitive, short-sighted and ultimately self-defeating policy be abandoned. Instead, if massively burgeoning deficits are to be arrested, we urge the members of the Senate to begin a long overdue evaluation of the military budget, to seriously consider repeal of the pending stages of last year's highly discriminatory tax cuts, and to probe carefully the massive revenue outflow in off-budget programs and tax expenditures. Certainly the programs which aid the poor, and over which this Committee has jurisdiction, have already been cut by more than their fair share.

If changes are to be made in the AFDC and Medicaid programs in FY 83, we believe they should be made on the basis of real-world economic problems, not myths and prejudices. Restore effective work incentives for those on AFDC instead of punishing the working poor. Mount a major national effort to contain health costs and rationalize the health delivery system rather than slashing federal support for essential health care for indigent families who rely on Medicaid.

CSS has long been in the forefront of those who seek effective reorganization of the welfare system. We have been critical of unnecessary bureaucracy; wasteful, duplicative organization and paperwork; and service delivery systems which sometimes ignore the real needs of people while maintaining outdated programs and institutions. What we see proposed in President Reagan's budget is not "reform" of the welfare system, however, but its arbitrary destruction.

We will continue, therefore, to speak out against those proposals which harm the millions of persons who through no fault of their own must rely on public assistance to survive. We will continue to monitor and analyze the results of programs already adopted and to suggest alterations in programs under consideration. We will continue to inform this Committee and its members of our findings and hope to have many more opportunities in the future to discuss ways in which we in the private sector can work effectively with Congress to achieve true welfare reform.

3/12/82

Mark Vayda
Political-Economic-Market
INTERNATIONAL CONSULTING
P.O. Box 3265, McLean, Virginia
22103 tel: (703) 734-1986

The Committee On Finance
The United States Senate
Room 2221 Dirkson Building
Washington, D.C.

Mr. Chairman and Gentlemen of the Committee:

Here is the only way to balance the budget that would be acceptable to all. It is simple, equitable and palatable. Just a small four(4%)percent "Investment Stimulus Fee[1]" fully refundable via income tax credit at year-end, would eliminate the $100+ billion deficit and create a possible surplus[2] for Fiscal 1983! It would also give all competing political factions what they say they are seeking:

- The Administration: Tax Cuts Untouched; No Increase in Income Tax; No Cuts in xyz programs, Especially Defense.
- Congressional Liberals and Moderates: No Curtailment in Social Programs: Trim the Budget Deficit.
- Congressional Conservatives: A Balanced Budget; No Cuts in Defense

AND, ACCOMPANIED BY EVER LOWER PRICES, IMPLEMENTATION OF THE "FEE" WOULD:

- Immediately launch the biggest manufacturing and construction boom, including housing, in U.S. history.
- Evolve into a permanently fully employed economy within two(2)years.
- Provide a means of eliminating income tax within five(5)years.
- BE WELCOMED by all consumers, workers and producers.

CAN ANY CONSCIENTIOUS LEGISLATOR or ADMINISTRATION OFFICIAL AVOID GIVING MOST CAREFUL CONSIDERATION TO THE "Investment Stimulus Fee[1]"?

If the following discourse interests you, please note that I am willing to work with anyone with the dedication to follow through. I am available to answer questions, discuss, testify, lecture, or whatever for this non-inflationary, non-punitive, success-guaranteed solution to our economic and tax problems, consistent with the origins of our unique, democratic country. I welcome your comments whatever your level of commitment to the program succinctly explained in the attachment.

Respectfully submitted,

Mark Vayda

(See footnotes & definition summary at end of proposal)

[1] Not a form of Sales or Income Tax

[2] A surplus could occur the very first year.

> " ... fellow citizens ... a wise and frugal
> government ... shall not take from the mouth
> of labor the bread it has earned."
>
> -Thomas Jefferson
> First Inaugural Address

"A Case For The "Investment Stimulus Fee"

by Mark Vayda

"We must develop and implement systems that will assure that private enterprise becomes workable for all men of average competence* or we will lose the opportunity to have it work for any man!" (see page #27) ..Mark Vayda

---

*Of course, involving all of those who can produce, ever more effectively in the productive process, lightens the burden and increases the benefits available, from whatever source, for those who cannot attain average competence. MV

How To Launch
A Permanently Full-Employment, Private Enterprise Economy[3]
[achievable in any free country within two(2)years]

... and, in the case of the U.S.,...

BALANCE THE BUDGET - 1983

©Copyright 1982, by Mark Vayda

Page Nos. **Outline of Subject Matter**

1a,b,c,d,e • Summary (plus Charts and Graphs)

2 - 6 • Introduction: Historical perspective leading to author's theory of "Equitable Private Enterprise, A Genuine Third Position", of which his permanently full employment concept forms a part.[3]

7 • Overview - Listing Some Major Advantages

8 • Relationship Between Land Prices and National Economic Development - Worldwide.

9 -10 • Evolution of U.S. Tax System - Compared to Other Countries.

10-11 • Negative Effects of "Unimproved" and "Control Appreciation".

11 • Impact of Unimproved Apreciation on US. Economic Squeeze.

12-13 • Compound Negative Effects of Sales & Income Tax on Everyone.

14 • Negative effects of Sales and Income Taxes (Summary)

15 • How to Implement the "Investment Stimulus Fee".

16 • Application of Fee to Individual Home-owner.

16 • New Revenues (1983) Accruing to U.S. Federal Government From "ISF".

17 • Dangers of NOT Promptly Implementing "ISF".

19-20 • Advantages: "Investment Stimulus Fee": For Individual Citizen; For Business; For the Government

21-25 • Some Typical Questions and Answers.

26-27 • Summary of Footnotes and Definitions.

- Note: Except for use by the Congress of the United States in conjunction with the preparation of the U.S. Budget-1983 and in publications of the Congress, publication or reproduction of this document and attachments, in whole or in part, must be with prior approval of the author who retains exclusive rights to this material.

---

[3] Extracted from 'The 'KNOW WHAT YOU STAND FOR' Letters of Thomas Jefferson II
Authored and published by : Mark Vayda (P.O. Box 3265 McLean,Va.22103)

Summary

The purpose of this discourse is to establish the validity, palatability and expediency of a very simple, non-inflationary way to balance the budget, launch the greatest re-industrialization in history and, within two years evolve into a permanent, fully employed economy. The solution is applicable to all private economy countries. It is to be expected that the incontestable success that follows will dissipate the competitive hate of actual, as well as imagined inequitites in the U.S. and other private enterprise economies. With today' communications it would not be long before even our most dangerous adversary nations would find themselves compelled to imitate our exponentially more successful example, including the greater-than-ever freedoms implementation of this "solution" would necessitate. Would not such a sequence of events move us a very long way toward a strife-free world??

Without this "solution", and resultant success, which I shall demonstrate are so easily within our reach, we are in great jeopardy. Despite fundamentally faulted systems, during the past decade some of our socialist-communist adversaries have achieved hard-product growth rates up to six times that of some private economy countries including the United States. Meanwhile in the U.S., the industrial disincentives, of which the most important is the tax structure, have converted the U.S. into a "most rapidly de-industrializing nation"!! With the U.S. now importing the majority of both sophisticated product and basic manufactures, and only thirty(30%)percent of the work-force still employed in the manufacturing industries, we are ill-advised to consider ourselves secure economically or politically, let alone militarily!

The hate-inspired rhetoric of leftist totalitarians, in and out of power, will continue to make trouble for the private economies, especially the democratic ones, any time that all of the important indices in the U.S. do not far exceed comparable indices within those totalitarian, planned economies. However, it would not be difficult for us to, almost immediately, turn around our negative indices and permanently outdistance all of those adversaries through implementation of my surplus-generating "solution". I have called this solution the "Investment Stimulus Fee", which creates a budget surplus in the process of stimulating a permanently fully employed, non-inflationary, private enterprise economy capable of generating the highest, most balanced economic growth rates in history!

You may find it surprising to hear that the resolution of our most complex economic and socio-political problems can evolve from the implementation of a simple "Investment Stimulus Fee".

I believe in the good intentions of my fellow Americans and our political representatives. Because of that faith I am taking this occassion to bring to you for careful attention, a solution to our present economic dilemma. That solution, the concepts on which it is based, and the observations from which this concept was synthesized are the result of my nearly thirty years as an international market analyst, giving the necessary attention to political-economic factors. From that perspective I have been able to view economics in a way that few persons have been able to share . Those with whom I have spoken have urged me to do so now.

In the next thirty pages is an attempt to briefly expose you the observations and axioms pointing up a "missing link" needed to make private enterprise economies always effective for everyone. Here I attempt to reduce that logic to four brief pages. This Summary will have to leave questions unanswered necessitating the reading of at least the thirty page discourse, if not further reference to the author and possibly his related writings. So here is a summary of the observations[o], axioms[ax] and deductions[d] leading to the 'solution':

1. "The Poorer Countries Have Higher Priced Land Than Successful Countries.[ax1]"
2. In almost every instance, the nations with the highest land prices are the same nations suffering from the highest inflation and interest rates.[o1]
3. The reasons for these anomalies are always the same: The Poorer Nations Obtain Relatively Lower Percentages of Government Revenues From the Land Than Do the Economically More Successful Countries.[ax2]
4. High Land Prices Have an Exponentially Negative Effects on New Investment in Industrial Development, limiting introduction of new, more competitive product[d1]. Limited development, of course, limits employment opportunities and the resultant development of new skills and knowledge.[d2] It also results in higher prices from existing product suppliers.[d3]
5. Without sufficient "Stimulus" to assure that land is utilized in accord with the age-old concept of "Best and Highest Use", existing investment, including land, buildings, - and sometimes even existing factories and product lines, become more profitable than innovative, productive new investment. This condition is due to phenomena that I call "Control" and "Unimproved Appreciation", which, in turn, have their origin in a phenomena that I call "maximum discomfort level"[5,6,&11] (Without a full understanding of these phenomena the full impact of the recommended "solution" can never be fully appreciated.)

[5,6,11] See Footnotes and Definitions.

[ax1] This comparison, of course, applies to private economy countries only. (See pages 8&9)

6. Every dollar earned in "Unimproved Appreciation" results in a multiple factor of dollars removed from productive investment with all the obvious consequences for the economy and the ultimate consumer. These phenomena frustrate the innovative would-be entrepreneur, contribute to business cycles and overall instability effecting all members of society.
7. Another axiom that I call the "Natural Order of Economics and Profit": We are born consumers and remain consumers until we die; thus consuming is our first order of priority. Second we are entrepreneurs. Third we are worker-producers in the service of successful entrepreneurs. Fourth we are contributors to our fellow man. It is important that tax and other law conform to our natural order of priorities.[23]
8. It is generally understood that sales and income taxes fall hardest on the working poor. What is not generally understood is that every dollar of sales or income tax you pay not only leaves you one dollar poorer, but makes everything that you buy cost more by a compound factor of the dollars taken from you in tax, i.e., Inflation.
9. Also, the only beneficiaries of inflation are those holding major "underdeveloped assets". These are mostly non-productive assets such as raw land, which appreciate faster than the general rate of inflation thru what has been described previously as "Control Appreciation". So, in truth it can be said that the re-distributive sales and income tax system acts in reverse of its supposed intention by making the non-productive rich, richer and the working poor, poorer.
10. The U.S. is the only country that started with the land tax the only legal tax on its citizens. Land tax stimulates the owner to produce or sell(rather than withhold investment by others)resulting in more investment, jobs, lower prices, etc. This is why I call it the only capitalistic tax: A land tax is the only tax that can be thrown in the ocean after collection and everyone, except the pure speculator, is better off than before the tax was implemented.
11. Since inception we have been applying socialistic solutions to cure capitalistic problems ... and they have not worked. The land tax is an example of curing capitalistic problems with capitalistic answers.
12. But by now you and I have become the victims of our many millions more recently arrived Europen ancestors, who brought with them the the centralist, socialist thinking, remedies and systems which were the root cause of the fixed hierarchy of man-over-man, limiting individual opportunity, which they supposedly fled Europe to escape. Of course these systems are eroding our founding fathers ideals of economic and individual freedom.

---

[23] See page#3.

12b. The result has been government sales and income tax expenditures increasing 20,000% during the last fifty years, and control ppreciation of land has increased even more!

13. "The Catch Twenty-Two"

13a. In our present state of low competitiveness, (witness negative balance of trade) while interest rates remain high, the consumer market will be less than normal, decreasing incentive for manufacturers to invest in improvements, compounded by the interest costs for new improvements and for carrying even normal inventory. Hence, much of industry will continue to lose money and even fail until costs of labor and materials drop to a level competitive with foreign suppliers. The result is called recession ... or even depression. This will be further exacerbated by any rise in Sales and Income Taxes. see pages 13&14. With US industry already reduced in both competitiveness and size, to a lower percent of our working population than anytime in this century, consider the possible political consequences of permitting a further curtailment of industry and employment.

13b. If interest rates drop before American industry is once again competitive with the imported product, all of the savings which have been encouraged by high interest rates, will siphon off, once again, into investments offering "Unimproved" and "Control Appreciation" creating further inflation and further weakening the economy. Am I saying that there is no answer? Not in the least! ... Here is a workable answer:

14. Just a simple four(4%)percent ('average-rental value-of-land') "Investment Stimulus Fee", fully refundable via income tax credit at year-end, COULD RESULT IN BALANCING THE US BUDGET-1983, while inducing new and existing industry to invest in the most competitive and biggest, most permanent, non-inflationary boom in history, providing the conditions for phasing out of all forms of economic regulation. The US would be performing like a private enterprise economy is supposed to perform: offering an ever broadened line of ever better better goods and services at ever better prices!!!

15. The result would be the first time that no one would have any reason to feel excluded from the economy, as within two(2)years there would exist more than one challenging job for everyone seeking to work!! This would remove any pretext for artificailly controlling the price of labor, as a genuine competition by employers would exist for the services of all levels of employees!!! This is what I call "Curing Capitalistic Problems With Capitalistic Answers!"

After reading this proposal, I would appreciate haering your comments. I shall then send you supplemental data now in preparation, including a "Comparison of Re-industrialization Incentives" showing that the "Investment Stimulus Fee" is the only positive stimulus for existing & new industry.

• Introduction: "Two Wrongs Don't Make a Right", or, "Shame on Both CONSERVATIVES and LIBERALS"

To me the launching of the world's first successful democracy was the zenith of man's philosophical achievement to date, as was the capitalistic miracle that followed; so inextracably tied to the free man, the free vote, and the right to acquire and hold private property, over any and all others.

Of course, like any concept so revolutionary, there were some "missing links"- of which some have become almost full-time occupations for us today. Perhaps the most important of these was and still is the development of a (capitalistic, individualistic thus economically viable) solution for bringing all those who are able into the productive-consumptive process, and providing a network that adequately cares for those who, for no fault of their own, can never be a part of this process.

By now you and I have become the victims of our more recently arrived [multi-millions] of European ancestors, bringing with them the thinking, remedies, and resulting centralist, socialist systems which were the root cause of the stifling, fixed hierarchy of man-over-man, and the limited individual opportunity, that they supposedly fled Europe to escape.

The resulting collage of an economic system I suppose we would call "Welfare-State-America". It now has grievous problems, in many respects greater than at the founding of the young republic. Firstly, most of us would admit that the approaches taken to resolve the problems of the 'needy' to date, have only served to weaken the efficiency of capitalistic enterprise. Secondly, the process of attempting "to take from the rich to give to the poor" is totally alien to the original concept of freedom in the United States. Thirdly, it has not worked ... it has not resolved the problem for those at the bottom of the economic ladder. The spread between rich and poor today is greater than when these programs began to receive major support (i.e., 1932) and the percent of people below the poverty line is bigger than ever (following fifty years during which the size of government has increased 10,000 percent!! Do you know ANY other statistic that even came close to growing that much in the last fifty years?[4] . . . Is it not time for a cost-benefit analysis?

---

[4] Yes, in this time interval there has been but one economic statistic that has equalled and surpassed the growth of government: The increase of values in land and property in situations of close "Control Appreciation", in many cases exceeding twenty thousand (20,000%) percent during the same period!!! (See footnote 4, page 26)

Let us, for a moment, reflect on what I call "The Natural Order of Economics (&profit) From the moment you are born and take your first nurishment, you are a *consumer* ... and you never quit until the day you die. *Consumption* would then be your *number one priority*. Your *second* level of action is *creative, or entrepreneurial*, witness the externally-internally oriented child making his first creative marks on a piece of paper.... While that creative entreprenuerial activity is generally intermittant, it remains the avenue through which man contributes most to himself and to his fellow man, and thus should remain in second place. The *third* level, through which most of us must pass, is securing and carrying out a job in search of a livlihood, as a *worker* in the service of a more successful entrepreneur. Of course, the *fourth* and final level of involvement comes from our *"surplus"*[2] time and funds, commiting our energies *to help others* (utilizing the knowledge we have extracted from the experiences our life-times.)

Would it not seem natural then, that our elected representatives should follow a similar order of priorities in their efforts to protect the interests of the citizen? Does this mean that I am suggesting that we should be fed, housed and clothed by the State? ... by no means! But it *does* mean that, without the express permission of the voter, *nothing* should be done to interfere with the bringing of *more, better* and *less expensive goods*, *more accessible to the market* place, *and to the consumer.* In its *crudest* form, capitalism *supposedly* achieves these objectives (and very well it might if it were not for a "missing link" required to cope with *a concept of paramount importance*, having a major negative effect on *all* economies, which I call *"Maximum Discomfort Level"*[5]).

As long as a "system" were to provide all the welfare-state benefits, wouldn't even the socialistically inclined welcome the chance to "stimulate" capitalistic enterprise to fulfil its function better than ever: bringing greater abundance, more variety, more economical, and higher quality goods and services to market than any other system ever has or ever could provide the consumer? Well, that is exactly what the "Investment Stimulus Fee" system purports, and WILL DO!

As presently constituted one group would be less than enthusiastic about the new "Fee" because it would make more work for this group of 'capital-holders' (note, I did not say entrepreneurs) who, in a comfortable form of conservatism, align themselves almost religiously with aggressive liberals pressing re-distributive measures "designed" to remedy the problems of those at the bottom of the economic latter. It is impossible to know whether either of these groups fully recognize that these re-distributive measures have to create inflationary effects leaving the poor, poorer than before;[4] and those "conservatives" (supposed targets of re distribution) the beneficiarie with non-productive assets increasing in value[6] at a rate far exceeding taxes imposed, or any effect of inflation on their other activities.

---

[5] See Definitions page 27.

Am I here suggesting another "robinhood" scheme under a different guise? Far from it! The rich having the capital doesn't do anybody any harm. What is harmful, in my moralistic, socio-economic judgment, is the flow of major investors toward the more "underdeveloped"[7], so-called 'conservative' investments. Worse than non-productive, these act to restrain productive investment, and for so doing, attain a yield far higher than the productive entrepreneur. This has a major negative effect on the economy, as explained within the following proposal[8].

So, in summary, we note that neither the actions of the Liberal or the Conservative do anything in the way of increasing competitive, innovative production. The actions of neither of these political groups assist in the production of more, better, less expensive, or more varieties of goods. To the contrary, as the attached will adequately demonstrate, the actions of both add to the costs of all consumers, and benefit only the holders of "underdeveloped capital"[7] and those who have the 'good fortune' to have a portion of the "public trust" under their direct control.

What is 'missing' then, is an effective "stimulus" to the large holder of undereveloped capital encouraging him to either assist the innovative producer, or compete with him, in accelerating the development of improved products, and/or intensifying the level of competition, to the benefit of the consumer. It is important that the largest holders of underdeveloped capital be "stimulated" to particapate in this constructive process.

We have often heard of the phenomenon of "over-production". Until every man, woman, and child in the entire world have sufficient food clothing, housing, and transportation, there can be no such thing as 'over-production'. Then what we really experience periodically, and even on a continuim, is a vast problem of under-production, under-utilization of resources, (including human capital) and under-distribution of finished product ... that "stimulated" capitalism can accomplish faster, cheaper, and better than any other system. Along with the concept of 'over-production' is usually mentioned the even more widely-held misconception: The "inevitability of business cycles".[9] If we ever get the theme of this proposal off the ground, I shall be happy to convincingly demonstrate

---

[4,6,7,8,9] See Footnotes and Definitions, pages 26-30.

that 'business-cycles' need not be inevitable!

Certainly, after balancing the budget, attaining full employment, and continually lower levels of prices, there will remain other major social and economic problems for resolution. However, in addition to solving the former, as this proposal promises to do, it is also my not-too-modest aspiration for this proposal to introduce our legislators to a new method of analyzing cost-benefit-ratios, teaching them no net gain can be achieved in attempting to resolve a problem in a way that involves taking from the "motor-power[10]" (i.e., taxing the income) of the nation!!

What I am, in effect suggesting then, is that we begin to seek "capitalistic answers to capitalistic problems" rather than continue to attempt to solve capitalistic problems with "socialistic" answers. That futile course is like our old saying of "mixing oil and water ... they just won't mix". All it can do is render capitalism ever more ineffective until it eventually succombs to a much less efficient and personally less satisfying "militant socialism". I hope there are not many seeking a socialist solution, but, without changing course, if you doubt it will happen, I am willing to wager you that I can prove it will, to any human being willing to reason with me. All my money is also available to the thinking person who I cannot convince that socialism ultimately has to lead to a loss of individual rights and liberties, preserving no vestages of genuine individual democracy. ... Just try me!!

Americans must become idealogical! What is our idealogy? Free elections, a free man, free association and the sacredness of private property. This all we have to sell, and indeed, sell it, we must. The resultant dictatorships of all other elitist, centralist states, will not relent in their efforts to destroy any vestage of democracy, against which an informed free man will never knowingly select. Our continuing interferance with the election in El Salvador, in support of an elitist dictatorial land and bank nationalization, will require quite some time for L.A. supporters of USA and freedom to forgive &forget!

So where does all of this leave us? Simply with the task of purifying and humanizing the beautiful old concept of "Free Enterprise" in a way that will add to its efficiency rather than subtract from it. It is just plain amazing to me that, with all that has been written about the private enterprise system, that no one has ever attempted to "work with it", that is to say "enhance" it. It reminds me of the socialist concept of human nature which they treat as bsically flawed, requirin force to overcome, instead of finding a way to work with and use man's basic nature for his and everyone else's benefit. The same goes for capitalism. We must learn to work with it and maximize its usefulness to man, and yes, even improve its efficiency ... but that would require understanding its full nature, in which understanding, I am afraid, as a nation we are sadly lacking.

The capitalistic answer which I promise in this proposal involves an "Investment Stimulus Fee" which will supply the funds needed to continue the present level of "social benefits" for as long as needed or desired However, the "Stimulus" eliminates the need for many of those social benefit programs, and in the process, the use of the "Investment Stimulus Fee" should teach an entirely new way of resolving future social and economic problems.

It is an approach that faults current positions of both major political positions yet gives each what they say they are seeking:

- Conservatives: No more tax on Productive Income;
  An opportunity of more businesses to be more successfu
- Liberals: Ample funding for Social Programs oriented toward
  those at the bottom rung of the economic latter.

o ...(and I know that the worker-consumer and the productive-entrepreneur would jump through hoops in order to have this program enacted)

I began this Introduction stating my belief in the good intentions of my fellow Americans and our politicians. Because of that faith I am taking time to bring a new, and far-reachingly effective solution to your attention. The solution, concepts on which it is based and observations from which these concepts were synthesized, are the result of spending thirty years as an international market analyst, with the necessary attention to political-economic factors. I have been fortunate enough to be able to view economics from a perspective that few have been able to share. Those with whom I have spoken have urged me to do so now, and it is in this context that I am contacting you.

Assuming that you find the concepts and resulting solution as comfortable as I do, where do we go from here? First, I look forward to hearing your reactions; answer any questions you may have, and offer you supplemental data, such as a comparison of economic costs and yields of the various re-industrialization incentives, including the "Investment Stimulus Fee", the tool recommended here for balancing the budget.

"HOW TO BALANCE THE US-1983 BUDGET IN A WAY PLEASING TO ALL, AND CREATE A Permanently Full Employment, Private Enterprise Economy

[achievable in any country within two (2) years]"

© Copyright 1982, by Mark Vayda

Here is a simple explanation of how to create an economy of unparalleled material and spiritual success anywhere[12] (ranging from the U.S. to El Salvador to the Zimbabwean Republic. The first country to implement this system of stimulated private enterprise will create, for the first time in history, a permanent excess of demand (by employers) for the services of labor, with all the benefits for labor, and the economy, that this implies. The result is a nation where, stimulated to divert their wealth to more productive enterptise, the rich gain wealth faster than ever before ... yet in creating new product and wealth, circumstances are created wherein the poor's disposible income improves even faster ... the income distribution "gap" between the well-to-do and the working poor begins to close. (Both rich and poor will benefit most markedly in the poorer third world nations choosing to implement the plan.)

This plan will place any nation[12] on a course satisfying to all its citizens within a month or two, and result in full employment and optimized economic conditions on a permanent basis within two (2) years! Quite a promise for two short years ... or any length of time, isn't it? Some of the more striking of these optimized conditions include:[13]

1. At least one productive employment opportunity for every person seeking to work.
2. An immediate and increasing budget surplus (with ever lower punitive taxes on investor-producers, workers and consumers).
3. Lower, non-inflationary prices, higher "real" profits, and much lower interest rates (e.g., two(2%)percent).

Depending on other vital but even simpler to implement enhancements, these additional benefits are possible:

4. No more nation-wide recessions or business cycles ... ever again!
5. A consistent balance of trade and a stable, highly valued currency.
6. A greater level of freedom for the individual and the corporation.
7. (Of course, all of the above would tend to increase individual, national and international security, creating a climate for growth of individual and national self-worth, at rates of advancement unthinkable in this world of ours today.

---

[12] See Footnote summary pages 26-30.

[13] For mor complete list of advantages see pages 19-20.

• Relationship of Land Prices to Economic Progress - World-wide:

Let us now begin by considering a very important axiom of mine, not generally recognized and therefore the implications of which have here-to-fore not been adequately examined:

"The Poorer a Country Be, the Higher the Price of the Land!"[14]

Amazing, isn't it? ... But true! (There are some exceptions but their circumstances only further reinforce my conclusions and suggested solutions.) This anomaly has profound negative effects on the U. S. economy, as well as that of every other nation in the so-called "free-world". It is a primary "disincentive for investment in development". It is obvious that a high land price is a major deterrent[15] in attracting productive investment to a developing country. Just as obviously, land prices can be a determining factor for new industry selecting among otherwise comparable sites in highly developed nations. Even when nations start at the same general level of development, their differing "policies" vary the speed of development. Just which policies? ...and why? The nation that stimulates the most intensive use of resources (i.e., land, minerals, existing plant--plus uncommitted financial and human capital and, of course, attracts foreign investment) registers the biggest increases in GNP, net worth, and, we are told, provides the greatest level of improvement for all its citizens. Without interaction of the land, nothing happens.

Why then do not land-owners and development commissions in the poorer nations attempt to make their land-holdings attractive to the world financial markets? Answer: These poorer nations with the high priced land are generally the same ones experiencing the highest rates of inflation. The large land-owner participates generously in inflation by a phenomena I call "control appreciation[8]," and therefore has little incentive to make accommodations to foreign buyers. Development commissions often operate on the thesis that high land prices help to assure an adequate participation for their "native (land) investor" in joint ventures with foreign investors. (On another occasion I shall be pleased to suggest other more effective, and equitable, means to raise investors in the poorer countries to a level competitive with those from the investor countries.)

---

[15] Of course their are other deterrents to development. Those not covered here can be analyzed for you at a later date.

[14] ... And the lower the percentage of government revenues that come from the land.

• Comparative Evolution of Taxes in the United States and Other Countries:

Do you know which country (until recently) had the lowest land prices (for comparable use) among all countries where land is a freely traded commodity? Yes, it was the United States where traditionally a larger portion of government revenues came from real estate than any other country. A land tax stimulates owners to follow the age-old real estate maxim, "Best and Highest Use," or sell the property to someone who will. Did you know that for the first ninety years of U.S. History (from the Boston Tea Party until Lincoln introduced a sales tax to pay for the Civil War) the land tax was the only legal levy on the U.S. citizen? Here is an example of how it worked: By the time he became President, George Washington was a very wealthy man. He owned 9,000 acres of first class farms on the Potomac and 30-40,000 acres in Kentucky. However, his less productive heirs lost the land by the time of the Civil War because they could not pay the land tax![16] The new buyers had to be convinced that they could make the land pay off (to do so requires new investment, resulting in more jobs, increased competition, lower prices and an improved living **standard for everyone**). In contrast, General de Velasco was awarded one-third of Cuba for defending Havana against the English in 1654. When Castro took over in Cuba in 1959, de Velasco's heirs still owned most of that land, including a still undeveloped parcel, bigger

All de Velasco's heirs[16], like those I knew, may have all been upstanding, hard-working people. Nevertheless, these heirs had to reach what I call "the maximum discomfort level[5]" in effort required to tend their lands, cattle, employees, etc., (at which point, for inability to make more intensive use of resources, a land-owner should be "stimulated" to sell his lesser-used property to the resourceful individuals, who in effect are offering to commit additional resources to seek "best and highest use" for the land). However, land taxes were non-existent to inconsequential in Cuba[17]. The U.S., has reversed its tax base from 1932 to present (Now only 20% of government revenues are land-related. The other 80% of the present tax base will be analyzed further on), and so the U.S. presently encourages an orientation toward "control appreciation[8]," and all the problems that it creates.

The same principles apply whether talking about the rural countryside or the slums of the inner-city. Slums generally develop on the periphery of the most expensive and highest use real estate. However, whether present owners be residing in the slum or not, searching for "best and highest use" is not how they will realize a profit. Because annual "unimproved appreciation[11]" far exceeds carrying costs in slum/high-use real estate (without applying the new concept of the "investment stimulus fee")[1]; owners will continue to restrain "active" productive investment[6,20] until their financial concerns, generally unrelated to the property in question, "stimulate" present owners to relinquish control.

---

[5] Understanding the definition of the concept of "maximum discomfort level" has major importance to understanding the"Fee" theory. Please read definition(pages 26, 27.)

- The Negative Aspects of "Unimproved" and "Control Appreciation":

Productive Capitalists attempt to earn a living, offering us a competing selection of new or improved products and services ... At whose cost and risk? Only that of these creative risk-takers themselves. ... And for whose benefit ? ... Amazingly, largely those who buy (whether you buy a new product offering or that of an established competitor, the competition will have a positive effect on the quality, price, service, or all three).

"Control Appreciation" frustrates or stifles the innovative and resourceful, raising the costs of introducing their inventive products and services to the market. Apart from the obvious effect of control appreciation on land prices and interest rates, other negative effects include: LOSS OF: 1) productive investment, 2) product improvements, 3) wages, and 4) living standards (not achieved)... AND prices continue to rise (only with intermittant recessionary relief).

The "Control Speculator" profits by delaying, or denying willing buyers access to his underdeveloped real estate investments. [Let us compare him to the productive risk-taker.] If the control speculator loses, who bears the cost? John Q. Public--always! ⟦ If the loss occurs in good times, the control speculator has already retarded the sale and caused some inflation. If the loss occurs in bad times[9], only another speculator would 1) be in a position to, and 2) wants to, buy.⟧

Now, ... what happens if the control speculator is successful? Only he is successful ... there are no fringe benefits for any part of society ... nothing becomes better, or less expensive. (Incidentally, the control speculator generally has the staying power to be successful.) What we are saying is that the control speculator's "risk," in a long-term inflationary, primary seller's market, is one of holding an asset (almost always increasing in market value), anticipating actions by others[16] which may "up-grade" or intensify the market accelerating the rate of "unimproved appreciation" during the period that the "control speculator's" investment is obstructing investment in productive improvement by others, and contributing to the cost of everything that we buy.

---

[9] With the Implementation of the "Investment Stimulus Fee", it is possible to diminish the significance of business cycles. More complete explanation under "Definitions pp26-28.

- Impact of Unimproved Appreciation on Present U.S. Economic Squeeze:

In the period (1932-82) when the U.S. reversed from a "land stimulus" to a "tax-grab-from-income," everything from cars to coffee has risen in price from one thousand to three thousand percent (1000%-3000%)--an average of fifty (50%) per year... And that will get much worse... as interest rates drop, pressures of two years' limited housing starts, and persons "trading-up" with a similar fixed mortgage payments will rachet housing's percentage take of the individual's net income up still another notch. (Strange, isn't it, that the U.S., originator of a rudimentary land stimulus, would evolve to tax laws now reserving the highest level of rewards for those investing in "control appreciation" and obstructing the innovative risk-taker in his efforts to bring more economical, and improved, products and services to the market??!!)

Historically too little attention has been given to distinguishing between Productive Capitalism and Control Speculation[19]. Economists, inclined toward both the left and the right, have generally accepted "Land Speculation as an inseparable part of Productive Capitalism"(Wrong!!) But, by now I expect you can visualize how a proper form of "land tax stimulus" would render " Land Speculation"and "Productive Capitalism[20]" as very separate and distinct activities and easily isolated from each other. You have seen how "Control Speculation" counteracts the economics of Productive Capitalism that would bring prices down and quality up. It also thwarts major portions of the populus from entering the productive-consumptive sector to gain a their self-respecting share of the "fruits of production".

Without spending even one,red cent of taxpayer money, the "Investment Stimulus Fee" of this proposal creates an incentive to invest, in new and more productive assets, and improve productivity of existing assets ... OR... to sell to someone who will. The "ISF" is not intended for, nor does it result in, re-distribution of wealth. Its sole purpose is to stimulate existing capital sources (especially those currently involved in "Control Appreciation") to, directly or indirectly, invest in new or improved plant and product, from which, as we have already shown, the worker-consumer has to be the ultimate beneficiary.

Now you can appreciate why I say that:(differing from all other taxes):The "Investment Stimulus Fee" is the ONLY source of government revenue that CAN BE THROWN INTO THE OCEAN after collecting it, and that everyone, including the majority of land-owner-taxpayers, is better off financially than before the "Investment Stimulus Fee" was implemented.... Thus, I call it the ONLY tax for the advancement of a healthy and competitive capitalism (... for a healthy and wealthy economy and populus.)

It is not proveable whether the founding fathers of the United States fully appreciated the soundness of the structure they were launching with their land tax. It was the first and only example of men volunteering to tax their own land and avoiding all forms of tax on income of any sort. It probably was more out of compassion for those not yet having land,combined with their awareness of how the "evils" of "income related taxes" (i.e., sales and income) had worked in their own disinterest, that they selected the land tax on themselves as the only remaining alternative. HOWEVER, not only did their land tax move in a limited but positive way to emphasize productive investment over "control appreciation", but it helped them to avoid the very negative, or what the may have considered " evils" of income related, re-distributive taxation. (These taxes form the second negative force leading to the absolute necessity of implementing an "Investment Stimulus Fee"!!)

• The Compound Negative Effects of Sales and Income Taxes on Everyone

Are you aware of the fact that "For every dollar of SALES and INCOME TAX you pay, not only do you have less dollars with which to purchase your needs, but everything you buy will cost more by a multiple factor of the amount of tax you pay?!?

Does that sound strange??!! Well, it is just as true as the axiom about the price of land (i.e., "the poorer the country, the higher the price of land")!...and the combined effect of both of these axioms on all of us, the John Q. Publics of this world, is absolutely disasterous! If we had the benefit of a land stimulus fee in existence during my lifetime, the average of us would only need to work two (2) hours per day by now, to live at a far increased standard of living instead of the now increasing burden on our large and ineffective service worker component and ever lower commitment to productivity and production. In the United States the effect has been to eliminate hard industry to the extent that only thirty(30%)percent of the work force is employed in productive activity. No nation in such condition can consider itself a world power, and secure against long run threats of force without further destroying the economy.

Now, for contrast, let us take a minute to simply demonstrate some important negative effects of Sales and Income taxes for any consumer willing-to-be-worker-producer within a society:

Let us suppose that you are a shirtmaker and I, a shoemaker. Let us say that I decide to quit making shoes and go to work for the government instead. My reasons are unimportant. I may be seeking higher pay, job security, fringe benefits such as vacation and/or retirement, or to train new shoemakers...or whatever. In any case, you have to pay a fraction more taxes to cover my new government wages. Let us say we are a small island nation and that your share of my new wage comes to an additional dollar ($1.00) in tax.

Here are some negative effects on your money supply, and the cost of what you buy:

1. Obviously, you have one less dollar (-$1) available to buy your next pair of shoes. -$1
2. I no longer make my own shoes, but still consume, so now I represent one additional consumer of shoes (causing a shortage of shoes and a pressure toward a higher price for shoes. (+$ cost)
3. I no longer make your shoes (or anyone else's) so, still less shoes are available for purchase, and those that are undoubtedly will cost you more. (+$ cost)
4. ...and we still have not done a thing in the way of helping train new shoemakers. (one more $1 please) -$1
5. ... nor have we given shoes to underprivileged... or whatever other supposed redistributive benefit the government had in mind for my employment in the first place. (Again, one more $1 please) -$1
6. The cost of production of your shirts, other shirtmakers and shoemakers, and other producers in society has increased because of taxes eventually to a point where other shoemakers, some shirtmakers, and even you may be forced to desert your field[14] as a shirtmaker, resulting in more government workers and/or welfare recipients bidding on an evermore limited and costly supply of shoes. -$2 (+$ cost)
7. Now the higher prices of domestic product invites foreign competition on the remaining shirtmakers and shoemakers, bringing about still another cost to you caused by an imbalance-of-trade and the subsequent "devaluation-of-currency" inflation. (+$ cost)
8. Those in power, attempting to show sensitivity to the worker (but lacking an understanding of product marketing economics) suggest wage increases to offset the accumulated inflation, depleting further corporate competitiveness and the possibilities of guiding capital toward productive investment. The result is a continual degradation of national product quality and net production and the collapse of still more productive enterprise, as industry becomes less and less able to absorb and/or pass-on increased costs... and costs will rise faster than ever. (+$ cost)

---

[14] See Footnotes page 30.

Summary of Some Major Negative Effects of Sales & Income Taxes

Now we have seen how each additional dollar ($1) of redistributive taxation, and my new government employment, decrease the dollars you have available (e.g., -$6) and increase the cost of everything you buy by a compound factor including at least the eight (+8$) cost/items that we have listed above. There are others; however, the above are sufficient to demonstrate that, not only is there "no free lunch," but that under the system of taxing sales and income, costs to both the provider and the recipient are so high that both have lost more through the future ineffectiveness of the entire economy, than the well-intentioned gift was meant to cost or provide. If the "market economics" exercise just discussed is not especially clear to you, I expect that you none-the-less appreciate how the "Investment Stimulus Fee", by activating as economy through collection alone, has some special advantages over sales and taxes, which must be spent to achieve their (questionable) benefits.

It is important to note that every dollar of sales and income tax increases the cost of U.S. manufactures increasing the advantages of the product of other nations over our own. It also increases the handicap for U.S. manufacturers trying to compete in international trade.

How to Implement an "Investment (Land) Stimulus Fee"

We have just seen how two extremely negative economic forces combine to dry up inventive, productive investment while causing all other forms of havac on the existing economy. You might now like to see how the "Investment Stimulus Fee" works in the process of developing a positive economy, in which neither of those negative forces can ever again have significant impact:

Assign a small percentage of the 'average usage rental income' from every unit (i.e., square foot) of land of the nation.[2] "Average" meaning that no one pays a "fee" rate based on his own specific holdings but rather on the average rental yield of the entire zone. "Usage" meaning the rental income assigned to an owner-occupied site would equal the rental income of one occupied by a lessee. "Rental Income" referring to the rent, or appropriate proportional income, distributed over every unit (i.e., square foot of land) assigned only to the active asset . The resultant "fee," of course, applies uniformly to all properties within the "zone," regardless of variations in level of development, present value, profitability or activity. "Zones" would be defined as adjoining lands of generally similar "categorization." "Categorization" may generally follow present zoning codes.

A change would occur in the percentage rate of the "fee" only when the selling price of property within the zone increased by more than the sum of the following:

a. The average (over all lands within the zone) of the interest cost for carrying unimproved lands only. geometrically accelerated rates of capital generation that result from an increasingly active, efficient productive plant, drive interest rates down to as low as two percent (2%).)

b. The actual improvements, or capitalization of increases in rental income (whichever is greater) for each property, totalled (for all properties within the zone)

Definition of "Unimproved Appreciation[11]"

The Selling Price [less the sum of the Purchase Price and (a)+(b)] equals what I term "unimproved appreciation." By increasing the "investment stimulus fee" rate to offset unimproved appreciation, the "fee" continues to divert "control appreciation" into productive investment. "Control appreciation" is the result of "passive" ownership, or investment in improved, or unimproved, land with or without the "purpose" of obtaining primary profit from delaying "active", productive investment or development.

---

[2] Payable in monthly installments.
[11] Above definition of Unimproved Appreciation(cross reference page

[Example-con't]

- Application of "Fee" to Individual Homeowner

For example, let us take a home-owner who represents the "average" in his "zone": A house valued at $100,000, located on a 10,000s.f. lot, with an alternative rental value of $10,000 per year. [Let us say his present taxable income is $30,000 per annum.] Let us assume that the "zone" does not contain commercial, or industrial property not does it contain any undeveloped land. Let us confirm that the home-owner's house and lot are truly representative of averaging the income per square foot, for all the land within the "zone". An annual four(4%)percent "Investment Stimulus Fee" would result in the home-owner paying an additional $400. per year (i.e., $33.33 per month) as his assessment. If the "fee" is set sufficiently high to limit "Unimproved Appreciation" to zero, like all other land-owners, the home-owner would be entitled to an income tax credit, to return up to One hundred(100%)percent of his "fee" from the national treasury "surplus" for that year.

- New Federal Revenues resulting from the Implementation of the "Fee".

The implementation of a four(4%)percent "fee" could generate well in excess of the following revenues for the U.S. Budget 1983. Here's how:

a) With more than eighty-six(86mm)million homes and an average rental of $7,000/yr., as reported by census, the "ISF" direct revenues for the residential sector would exceed $12 billion in new revenues from the "fee". Also conservatively estimated commercial and industrial sectors would exceed $20 billion and $18 billion, respectively. Sub-total ... $50 billion

b) The "stimulated" economy (without considering the savings in revenues from fuller employment, less welfare, etc.) additional revenues from already established taxes and revenue sources would yield a minimum of $50 billion. Sub-total ... $100 billion.

c) Assuming the necessary policy commitment to gradually reduce "unimproved appreciation" to zero, during the initial period new productive investment would be attracted into the economy at a level exceeding the following formula: (100 ÷ the going interest-rate for every dollar of "fee" collected) ; i.e., $50 billion x 100 ÷ 20 = $250 billion new investment. Applying a ten(10%)percent tax yield from established tax sources for the first year, new investment would yield an additional $25 billion. ISF induced revenue Grand Total ... $125 billion.[22]

Even when employing the sounded concepts , such as we have, economic projections are generally suspect. However, those informed on factors & statistics employed here will concur to their scrupiously conservative composition.

---

[22] There are other non-redistributive revenues measures also now needed which would further assist re-industrialization. Shall discuss on request.

• WARNING!! Dangers of NOT Implementing"Investment Stimulus Fee"

If the US. money supply increases, and interest rates fall before: The US Budget is brought into balance, and 2) a U.S. international "balance-of-trade" is established, [[and/or 3) before an "Investment Stimulus Fee" is implemented]], applying only conventional wisdom , the following events would seem to be all but inevitable!: A) a major devaluation of the U.S. dollar, and B) a surge of the worst housing inflation in US history will explode within less than three years. The lower interest rates would then siphon-off into the more secure areas of "control appreciation" (and speculative currencies, and arbitrage) much of the"savings"recently induced by low productivity and high interest rates ... savings that were"supposedly"ear-marked for investment in re-industrialization. Of course, until something is done to change one of the fundamentals that would once again make U.S. product competitive in the international market, (It would seem that the one change, palatable to all, would involve the implementation of the "ISF", around which politicians of all stripes could easily rally) there can be no re-industrialization that will be fully utilized, make American product more competitive internationally, and not become onerously expensive to long run American industrial viability and, even the consumer.

During this period, the poorer, non-capital-holding members of the population will suffer the most. Of course, their aspirations of owning their own home will become ever more remote (if events are permitted to run their course) as we move into the most rapid boost in housing costs in history!

Under the tax systems now in favor in the world, the poor - especially the working poor, can only expect to become poorer ... and the middle class will not fair much better. Who gains in an inflationary economy?...Primarily those who have the most value to"inflate"(e.g., land , building, factory, farm, mine, lumber, etc.). Their primary gain will not be from competitive production but in the "unimproved appreciation"i.e., higher prices for land & less effic- plant and product occuring at the cost of productive-consumptive society, (which just could not happen with an"Investment Stimulus Fee").

For all Americans, then would it not be more satisfying to start to establish the most efficient fully employed society in history in total keeping with our democratic and personal liberties? A society where the rich become richer than ever directing their capital toward improvements in production, product and service resulting in a rate of improvement in standards of living never before thought possible with the poor who wish to work advancing in wealth and income proportionately even faster!

(beautiful economic and social)

Would not such a condition in the United States do much to deflate that old 'hate-America' set at home and abroad who always seek our week spots, which as our problem has grown, dwells on the 'alienation' and 'second-class' citizen status for our unemployed and working poor. Never mind that these people are cared for better than those much further up the professional and cultural scale in other countries. Yet, in part, our critics are right... They won't, and we shouldn't excuse a lowering of growth rates, as well as active productive employment (which eventually hands over, not only higher standards of living to our adversaries, but endangers our very ability to economically and militarily survive in competition with these fundamentally faulted systems!) What I am saying is that we can take no relief in noting and analyzing the faults of "those other tyranies" if we do nothing to philisophically and economically improve the only system that can guarantee freedom ... the genie of Private Enterprise! If our adversaries, by whatever means continue to post "hard-product" GNP increases in excess of our own, it will only be a matter of time before we have fallen behind them in that all important factor called "standard of living", which in the minds of most of the people of this hungry world, is how success is judged, quite irrespective of any consideration of individual choice, freedom, and liberty.

(... in addition to advantages named on page #1 of this letter ...)

- Advantages of "ISF" to Citizen: As an Individual; For Business; For Gov't

- Advantages for Operation of Government:

  - Removes need for concern over funding of Federal Budget. A small four(4%)percent "Investment Stimulus Fee", in substitution for income-related taxes generates a revenue "Gross Surplus" (i.e., all the "fees" can be thrown into the ocean and the entire economy would be in better condition than before the "fee" was collected! ... something that no other source of revenue can assure us. The resulting boom economy, evolving toward full employment, can sustain the most extensive programs that would be then attempted by elected representatives interested in the genuine well-being of their electorate. Except for those engaged principally in land speculative activity, the "ISF" would have only positive effects on the income and financial resources of the individual.

  - Removes the need to consider "Inflation" as a cost in making the Federal Budget.

  - The "Investment Stimulus Fee", in the eventual fully employed economy, after attending to the remaining needs of the citizenry and the government, and retiring the national debt, would continue to generate ever larger "surpluses" which should be returned to the citizens by the most democratic process.

  - The"Investment Stimulus Fee" is the first revenue concept in history capable of keeping representative government out of debt. It establishes genuine, permanent cures for the basic economic problems plaguing the entire world, on which approach a new concensus should emerge. As long as "Unimproved appreciation" stays above zero, The higher the "Stimulus Fee", the bigger are the revenues of government -from all sources.

  - The "Investment Stimulus Fee" (compared to Sales and Income Taxes) is 1) much easier to initiate, install, administrate, ... and infinitely less costly in compliance to both the private sector and the government; 2) much easier to audit compliance, administration, and effectiveness of results; and 3) because of its structural simplicity, hopefully, will be less subject to 'tinkering'.

  - Formation of Capital: Assuming a commitment to gradually reduce "unimproved appreciation" to zero, initially, the "Fee" itself, would "stimulate" new investment at a rate approximating [100÷ the going interest rate x the total "fees" collected] The continually improving conditions would create and attract capital of unprecedented magnitude,including foreign sources.

- Advantages for Business:

  - Interest rates would gradually drop to historic lows in response the the increasingly competitive market for a geometrically expanding variety of goods and services ... matched by unequalled buying power in a fully employed economy.

  - The larger, more stable, rapidly growing markets (which, with some other matters adjusted, could avoid business cycles) would offer incomparable opportunities for new venture and new product planning.

  - The more competitive environment, especially with the"other matters" referred to above 'resolved', would assure A Balance-of-Trade.

(con't. Advantages for Citizen)

- Advantages for Individual
  - More abundant and more challenging jobs; no more 'make-work' jobs; No more able bodies on Welfare.
  - No futher need for 'cost-of-living increments to meet inflating personal budget requirements.
  - An ever shorter work week would number among the gains achieveable in an environment where employers would compete ever for an ever more productive worker.
  - More after-tax earnings for the worker. (Fees no higher than than sum of previous tax obligations (none for thirty(30%)percent non-owners) until "ISF" replaces all other income related taxes; While it is expected that the "fee will continue to grow, the real "net cost" in terms of what the ownerworker draws from the economy will become increasingly less!
  - Regular and increasing portions of earned income would be productively invested [illegible] the worker whose income and living standards ar advancing so rapidly. Worker would have more time to selectively shop and invest, serving both his self-interest and further honing the competition seeking his business.
  - Lower prices, of course, result from the lower rates of inflation, higher productivity, and intensified competition.
  - The (potential) absence of business cycles* would further stimulate the following: More innovative and marginal competitive product entries in the market place; More competitive quality, variety, price and service, and other non-price advantages.
- Miscellaneous Advantages
  - Eventual re-orientation of accounting and audit functions of both government and private sector would contribute much to product improvement and new venture planning, eliminating much of the negative activity now necessary in administering and monitoring more complex re-distributive tax systems presently in place. (I actually see a net gain in the need for accounting-trained personnel.)
  - A more important role for unions, generating interest by those not presently allied with their cause as unions begin directing themselves toward negotiating constructive formulas for retirement and profit participation in a fully employee marketplace instead of having to negotiate in the negative atmosphere of having to protect jobs, wage levels, etc.
  - Healthy attention would then be expected to turn to inadequacies in the treatment of other important interest groups in keeping with what must be described as the "natural order of economic interest":1) first of all we are CONSUMERS; 2) entrepreneurs, INDIVIDUAL STOCK-HOLDERS; 3rd) we are workers, including the non-union worker.

● Typical Questions and Answers

I expect, by now, the "Investment Stimulus Fee" is beginning to sound quite plausable to you. However, a solution that has been left unsolved for so long is suspect to most people. They begin to look for reasons why is unworkable, unfair, or unacceptable to some part of the populus. The following are some of the questions I hear from time to time concerning the "Investment Stimulus Fee." (I shall be pleased to amplify the answers, as well as address any others you might have.)

1. HOW CAN SUFFICIENT REVENUES BE DERIVED FROM A "LAND STIMULUS FEE" TO MEET ALL THE "NEEDS OF GOVERNMENT?"

a) Just to lend perspective in this confused world of ours, half-facetiously, I ask if the questioner is more interested in the "needs of government" than in the needs of the people government supposedly serves?' ...but then more seriously I attempt to address my response to the largest dollar figure the questioner could have in mind. Remember, just collecting the new "stimumus fee" provides an inducement to invest, and results in a major stimulus to the economy, and a treasury surplus. [As long as "unimproved appreciation" exists, the higher the percentage stimulus fee, the greater the revenue collection, as well as the resultant economic base on which the revenues are collected]... I then ask: "Just what percentage of present government services do you believe would be required to properly care for the public sector in a permanently, fully employed economy?" Their answers usually vary from thirty to sixty percent (30-60%) of present requirements. Interestingly enough, the aggregate of the land-owners in most countries at present provide in excess of 85% of their government's revenue from all sources including Income and Sales taxes. Also interesting to note, the largest portion of those revenues are contributed by the modest land and homeowner, middle-income taxpayer. (In some countries this distortion of tax burden against the middle-income taxpayer is further accentuated because of shelter provisions favoring the large land-owner/speculator, i.e., favoring "control appreciation.") To show the availability of revenues from a land tax, I offer the following example. (Of course it isn't an approach I recommend, but I believe it does serve the size of the revenue base obtainable through a land revenue approach.)

b) For just a moment, let us assume that we simply cancel everyone's sales and income tax obligations. Let us further assume that we increase each land-owner's property tax by an amount equal to his previous payments in Sales and Income Taxes ... who would be the loser? ...the land-owner would pay no more tax than before. Of course, he might be inclined to assess future investment decisions somewhat differently. Persons and corporations with large speculative land holdings would be "stimulated" to put more of their resources into productive investment or sell their properties to more aggressive persons who would. Everyone would then begin to derive the positive effects of lower price levels, improved living standards and the consequential peace and tranquility of society as a whole[8].

2. "IF THE 'LAND STIMULUS FEE' WERE TO REPLACE SALES AND INCOME TAXES EVENTUALLY, WOULDN'T THE ENTIRE 'BURDEN' FOR TAXES EVENTUALLY FALL ENTIRELY ON THE LAND-OWNER?"

Would you say that the land-owner was given a "burden" 1) if his total "net" tax bill was no greater than before, and 2) if his new annual benefits became a multiple of the sum of 1) his "fee" and 2) his after tax and inflation "net" annual unrealized "unimproved appreciation"[11] would you say that the land-owner has taken on an additional burden? The land-owner would gain in the following ways:

a) In the early years of implementation, the land-owner would receive a tax-credit against his previous level of sales and income taxes equal to his payment for investment stimulus "fee." (Note that in economic modeling, the newly stimulated economy grows sufficiently, that while major portions of sales and income taxes remain in place, the increased size of the economy provides additional revenues from added sales and income taxes far exceeding the original "stimulus" fees against which the credits were given-which stimulated the added revenue.) Of course the land-owner's tax-offset advantage would disappear after sales and income taxes have been eliminated... as, in a fully employed economy, would most unemployment benefits, and other negative reasons for those taxes to exist.

b) If the land-owner compares the new, uninflated cost of everything he buys[16] through the year to what those costs were before the

[11] See pages #15and #28.

"investment stimulus fee," the average home-owner (excepting those who had gained the majority of their annual income from speculation), would find that the "fee" develops an annual savings for the average land-owner well in excess of the sum of the fee and whatever future "unimproved appreciation" that no longer accrues to his property. (It is important to recognize that every dollar gained in "unimproved appreciation" removes a multiple of that amount in unrealized new "capital" otherwise available for investment in plant and product for production and consumption. That "unimproved appreciation" deprives people of jobs and improved living standards by a compound factor of that appreciation.) Have I shown you why "unimproved appreciation" in land and the compound negative effects it creates on the entire economy is matched only by the equally negative redistributive taxes we pay ... both favoring the non-producer/speculator?

c) If the land-owner happens to be a corporation, or is in business, the resultant economy (now devoid of business cycles) would make future planning and investment simpler and more secure. (From persons still believing the "investment stimulus fee" to be comparable to other forms of taxation, about this point I usually expect to hear the comment that the land-owner could be expected to "pass his fee on" to his customer. Fortunately or unfortunately, unlike all other forms of tax, the nature of this unique "fee" stimulates competition among suppliers of all types such that a continual "pass-on" is not possible.

- The corporate and business/product-oriented land-owners benefit from an ever-larger market for their products in a permanently fully employed economy.
- The high, stable value of the currency benefits the land-owner in international trade, and in domestically purchased foreign products. Of course a highly valued currency makes travel more appealing (and less expensive).

3. "BUT WHAT WILL HAPPEN TO MY POOR OLD GRANDMOTHER WHO LIVES ON HER PENSION AND/OR SOCIAL SECURITY CHECK? WOULD SHE ABLE TO CONTINUE TO LIVE IN HER OLD HOUSE ON MAIN STREET WHERE SHE HAS LIVED SINCE SHE WAS MARRIED?

That depends. If she is living in an area where "best and highest use" would dictate more rapid development (where she probably would not be very comfortable) she may find the stimulus fee to steep, but she would be able to find better housing suited to her needs (and possibly more to her liking) elsewhere for much less than she would have to pay under the present tax system. If, however, her old country house happens to be in an old country town, or on a dusty country road, it could be that her new fee would total less than her present taxes. In either circumstance, grandmother, like every other taxpayer, will pay less for all her needs, products and services, as either a fee-payer or non-fee payer in a lower cost, higher living standard, stimulated capitalistic society, in contrast to continually inflating costs under a system employing present tax methods. She would no longer need to worry about whether her fixed income pension would see her through, nor about her future financial plans being eroded by inflation. Grandmother would be less subject to the uncertain actions of government that could affect both her land and pension, as is possible under the present tax system and the less successful economy that it engenders.

4. "DOES THE LAND STIMULUS FEE INTERFERE WITH THE 'MARKET THEORY' FOR REAL ESTATE?"

The land tax concept preserves and accelerates all natural market reactions on improved and unimproved real estate. The tax must be implemented in a way that does not distinguish between levels of development within a tax zone. Using the market as the test does however tend to differentiate between passive capitalism (i.e., control speculation) and active capitalism (i.e., investment in productive development).

5. "HARRY HOMEOWNER HAS INVESTED IN A BIG HOME AT HIGH INTEREST RATES TO OFFSET THE COSTS OF INFLATION TO PROVIDE THE FUTURE CAPITAL THROUGH 'UNIMPROVED APPRECIATION' TO PROTECT WIFE WILMA AND HIMSELF FOR THEIR RETIREMENT. WITHOUT THE 'UNIMPROVED APPRECIATION' COULD THEY HANDLE THEIR RETIREMENT UNDER A SYSTEM OF 'INVESTMENT STIMULUS FEES' SUCH AS YOU PROPOSE?"

a) Harry Homeowner should be aware that even when appreciation on his home annually begins to rival his income, present out-of-pocket living costs and economic pressures affecting his future stability, including his job, are increasing by a multiple of every dollar that he now "earns" from that house in "net" unimproved appreciation.

b) I expect he is also concerned over the future of his son Harry, Jr. and daughter Jane. With continuing inflation, where are these young people going to get the money to even hitch their wagon to the "inflation rocket"? ...and if they do, how are they going to make the payments on a house that is going to be an ever greater percentage of their annual earnings? (While all other costs will continue to rise at similar rates.)

c) How about the kind of world Harry, Jr. and Jane will be living in? ... or for that matter, Harry and Wilma as well. With so many people's aspirations frustrated under the system caused by redistributive economics, the general run of people obviously will be harder, more self-seeking, and less concerned over integrity; crime will continue to rise.

d) Wouldn't Harry prefer a life where all of these indices improved every day; in a world where everything he purchased improved in quality and price continually ... like we have heard capitalism is supposed to work? A world where Harry, Jr. and Jane could begin to save for the future and know a maximum cost of their future needs, whether it be for schooling, housing, vacations, retirement, or whatever?

Footnotes and Definitions

Text/page

1/1 The "Investment Stimulus Fee" is not the usual tax on Sales & Income. Closer in concept to a "tax on capital" in the tradition of original American tax theory, the "ISF" increases the cost of maintaining real property so as to encourage or "stimulate" owners to improve or sell sub-marginal and non-productive lands and properties. [These sub-marginal properties have negative effects on the course of the entire economy. Without a sufficiently high "stimulus" fee, owners with sufficient resources find that they often can gain a premium, even over a successfully operating plant or property, holding the property off the market.] The "ISF" stimulates new productive investment, which in turn, results in increased employment, competition, and lower prices - all without spending one cent of the revenues collected! Unlike any other revenue measure, after accomplishing its just described primary function, the revenues collected are then still available to accomplish whatever functions of government remain in a "permanently fully employed economy". The proposal for implementing the "ISF" is one of slowly substituting a small, but annually increasing "fee" for existing income and sales taxes by means of a tax credit arrangement. An interesting aspect of the "ISF" is that while the present requirements of government should continue to decrease due to employing the unique revenue measure, the revenues collected by the government will continue to grow, presenting a new problem of how to democratically and equitably refund those revenues - of course, without defeating the original purpose of the "fee". In a philosophical sense, the purpose of the "ISF" is also diametrically opposed to any other tax. The primary objective of the "ISF" is to create new wealth, and in the process, expand up to full employment, the opportunities for productive enterpreneurs and those willing to work, to fully participate in a healthy competition for their products and services. It is accepted by any serious statistical economist that such a heightened level of competition by employer for both the services of labor and his place in an ever expanding market, will bring about the greatest cost efficiency, the lowest prices, and the highest level of real personal and business income.

1/2 The "Surplus" referred to here, of course, is the amount of revenues above the projected budget expense for the year. In discussing the "Investment Stimulus Fee" there are several other uses of the word 'surplus'. First, the entire collection of the "fee" is considered a surplus as contrasted with sales & income taxes because the "fee", in the majority of cases, does not come from consumable income or individual motor power. Even in those instances where the "fee" could possibly be considered as coming from consumable income, it is initially reimbursed via a tax credit. Once the fee attracts sufficient investment to increase overall competitiveness (which occurs prior to the "fee" resulting in a "net" tax increase to anyone who does not gain the largest part of income as "unimproved appreciation") the net gain via continually lower prices, (versus the now cyclic inflation and recession), and greater personal and business opportunities, will far outweigh the personal gains of "unimproved appreciation" (and all the consequential disastrous effects on the entire economy causing "unimproved appreciation". Second, 'surplus' has an important significance in relation to the "fee" because the percentage rate for collection, in concept, must gradually rise to the level required to keep "unimproved appreciation" from occurring, regardless of how far the resulting revenues might eventually exceed the required levels of expenditure for government. (The theory holds that revenues gained from what may be termed "re-distributive sources" should be declared unconstitutional once the effectiveness of the "ISF" has been proved in practice. A third type of "surplus" is personal time and funds expended voluntarily, for the benefit of other individuals, and/or the public at large. (ref: page#3)

"KNOW WHAT YOU STAND FOR" was the second title given to a draft manuscript covering a genuine 'equitable private enterprise' theory developed by Mark Vayda while sitting on his sugar mill equipment business in Cuba during the year following Fidel Castro's arrival to power. The initial effort was made to reach Castro with a ten-page letter on the subject. Later a letter was drafted to President Eisenhower's National Goals Chairman. The Cuban letter probably never reached proper level and went unacknowledged. The National Goals Commission letter received only a polite reply. However, in Nicaragua on a business consulting assignment in 1966, a chance encounter with Fernando Gordillo, then Nicaragua's most prominent communist leader, substantiated my belief that the equity of the concept would be equally acceptable to the honest intellectuals of both the left and the right. Within six months he became committed to the entire concept. Unfortunately, he died during the next year just prior to my scheduled trip to Nicaragua. I have a strong feeling that things might be somewhat different in Central America today if he were still alive.

2/3 Compound Negative Effects of Sales & Income Taxes: (See pages 13-14)

2/4 The U.S. Federal Budget has grown from $4 billion in 1931 to $660 billion in 1981. This growth-rate is surpassed by only one statistic in the same fifty-year time span: The increase in land and property values in conditions of close "Control Appreciation", which in many instances, have "appreciated" by two and three times as much as the stupifying growth-rate of government. (i.e., 20-30,000 percent)

3/5 "Maximum Discomfort Level" (could just as easily have been called 'Optimum Comfort Level') is defined as that financial and mental state reached at some point by an owner of land, or a plant or factory. It applies to the original entrepreneur himself in his more settled years, or to his heirs who do not add a personal dimension to the growth of the product through improvement in efficiency of the product itself or the economy of bringing it to the marketplace. It reaches its visible manifestation when the income, yield, and prospects for yield, exceed the owner's aspirations (versus the level of investment or effort he is able or willing to dedicate toward improving the efficiency and profitability of his "productive" investment). When that point is reached within the classic "land-inflationary" economy, generally there is no incentive to sell, because "unimproved appreciation" will take over and increase the value of everything from the land to the plant to the value of his end product. Within such an economy, the final sell-out for "unimproved", or in this instance "control" "appreciation", will reward the owner with a higher yield than any form of financial instrument he could buy (despite the higher interest rates prevalent in those inflationary economies) or, when the condition becomes sufficiently extreme, higher than he could achieve even by continuing on with the headaches as the productive entrepreneur. Of course, the "ISF" stimulates the owner to bring about progress, whether or not the plant is located on land belonging to the plant owner.

4/5 "...leaving the poor in greater poverty than before." The essence of this statement is that the inflation caused by "unimproved appreciation" and "re-distributive taxation both favor the person with the existing wealth, increasing the relative spread between the rich and the poor; and (while the re-distributive
can, with the presence of special circumstances, give a "quick fix" to the economy and/or the have-nots) the long run effects on both have to be negative, as I hope we amply explain within the context of this entire discussion.

4/6 "...and those 'conservatives', supposed targets of the re-distribution, become primary beneficiaries by having their major "unimproved" or "sub-marginal" assets increase in value at a rate far exceeding the taxes imposed, or the effects of inflation on their costs." The entire discourse will make this point apparent, however reference to footnotes 3/5 and 4/5 above, plus the definition of unimproved appreciation on page 15 will provide a quick concept introduction to the point.

4/7 "underdeveloped capital", "investment", and/or "real estate" all imply the same: The investment is not being utilized at a level to compete in a genuinely competitive marketplace. Furthermore, it generally follows that "income-from-operations" is not the primary cause for ownership...yet, as explained under "unimproved and/or control appreciation" the eventual profit from maintaining the "status quo" will probably be greater in the long run in a "land inflationary" economy, than if the owner had chosen the more agressive and risky course of the "productive entrepreneur".

4/8 What is harmful, is that an ever increasing percentage of capitalists are being attracted to so-called "conservative investments", the holding of which act to restrain productive investment. This process I call "Control Appreciation or "Control Speculation" which will gain increasingly higher yields in comparison with productive capitalism (with periodic recessionary blips) for as long as the system is able to survive. "Control: Appreciation/Speculation/Investment", as the word "control" implies, is simply a major and often the initiating force in the process of "unimproved appreciation" defined on page 15. For a good understanding of "Control Appreciation" see pages 9-12, also 8/6.

4/9 "Business Cycles" - It is generally accepted that business cycles are due to "an absence of perfect competition." I shall not enter into a debate on the feasibility of perfect competition. I will say that "ISF" will bring us closer to perfect competition than has ever before been experienced. Furthermore, "business-cycles", to the extent that they impinge on broad sectors of human life can be diminished to inconsequentials without reaching "perfect competition" when the "ISF" is employed per formula ... and ... no improper labor factors are introduced into the economy. (see footnote 10/18)

5/10 "Buying Power" is the earned income on which an individual and a nation depend for their very survival: sustenance, and improvement of same; i.e., investment in new homes, plant, production, product, and the like. When exchanges of old and existing properties occur at inflated figures, without added improvements, the whole economy, and, in certain conditions, the entire world is the loser, and suffers the inflationary consequences.

6/11 "Unimproved Appreciation" (technically defined at the bottom of page 13), generally stated, is the amount of appreciation that accrues to a property beyond the capitalization of carrying costs of the cleared raw land, and improvements, or improvement of income - whichever is greater. (also see 4/6; 4/7; 8/8; 11/19; and 11/20 ... pages 26-30).

7/1; 7/12 "...applicable to any so-called "free-world nation." To the degree that the basic rights of life, property, and the pursuit of individual happiness have been abridged the "ISF" stimulus will, of course be rendered ineffective. The countries of United States, El Salvador, and Zimbabwe were singled out for mention because the elected officials of each country were subjected to a very competitive, and, we are led to believe, highly ethical electoral process. Officials so elected feel no greater sense of responsibility to properly represent the interests of all the citizenry than officials arriving at or keeping office by any other means. In addition, each of these countries presently faces crisis level economic problems, with major political ramifications, which could be so equitably and simply resolved by use of the "ISF" stimulus. In each case, the time for implementation is now! If this only equitable solution is not implemented with all haste, the crisis level problems of each country can only grow worse in the long term ... and probably in the short run as well.

7/13 For a list of advantages of the "ISF" beyond those listed on page 7, refer to pages 19-20.

8/14 "The Poorer the Country, the Higher the Price of Land" ...and the lower the percentage of government revenues that come from the land. In case it was not already clear, I have added the second half of this axiom to confirm the direct relationship between the price of land and the tax incentive to "milk it or move it", as the old farmer used to say.

8/15 "a high land price is a major deterrent to development in developed and underdeveloped countries alike." Strangely, in all countries, peculiar rationales are given justifying and, in many cases implying that the high land price has some beneficial effect to it. Of course, there are other deterrents to development, but implementing the "fee" will cause the others to 'fall into place' and become less important, non-existent, or more easily remedied.

8/8 "Control Appreciation" is the same as "unimproved appreciation" except that it has, as the word 'control' implies, a major effect on the market place, and thus acts as a greater deterrent to economical development. For further information see footnote 4/6 and pages 9-12-13 of this discourse. (also see 4/6)

9/16 Heirs of George Washington versus descendants of Spanish General [illegible]. While some Americans claim blood relationship to those of wealth and importance in early revolutionary United States, there are no obvious chains of great dynasties dating back two hundred years in the United States. There are no great dynasties of wealth dating back that far like there are in other countries. In fact, try if you will to find another country that does not have a more visible continuity of wealth dating back two hundred years or more. However, since the tre[illegible] away from land based tax to redistributive taxation, our economic problems and establishment of financial dynasties have grown in direct proportion to the reversal of our traditional tax base as we have come to recognize and give something akin to monarchical and class-type deference to "old" wealth (when in most cases the last creative, productive enterprise was undertaken by their grandfathers). But who is taking time to analyze that such wealth, if invested (as we defined) 'conservatively', is really acting against a non-inflationary, effective economy (in which everybody's share of everybody's share of ever lower prices, higher quality and more available product would continually improve?) It is also interesting to note that recent immigrants, accustomed to operating in an atmosphere devoid of land and property taxes, have been the leaders in bilking our financial institutions, very rapidly establishing themselves as "landed gentry" in their newly adopted (or temporary) country - without contributing one iota of productive entrepreneurial activity to their own homeland.

9/17 "Land taxes were inconsequential in Cuba." In the years just prior to the Cuban revolution, the real estate "appreciation" accelerated at levels not experienced in the United States prior to the last ten years. As soon as a person joined the work force, his first thoughts were devoted to how he would amass the down payment for a lot ... i.e., his entry into the established society. The premium that they paid for that entry into the active economy was punitive. For most of them they expected a ten-year period before they could consider any other major expenses. However, as you would assume, the parcels from estates of the [illegible] and other important land-owners continued to "appreciate" in value, providing my young Cuban friends with a handsome profit whenever they decided to trade-out of the land ownership position. It should be recognized that precious little of this activity contributed to the production of real goods and services of consumable value to these young people, or to improving the standard of living of these aggressive, bright young people. It did, however prepare them well for maximizing their gain on our continually degenerating system in the U.S. as they arrived here as independent-minded political refugees. (Refugees from other countries I could mention are infinitely better prepared to maximize their gain from the degenerating system existent in the U.S. today.)

10/18 "actions by others" falls in several categories: The 1st refers to the actions of government officials over whom the "control speculator" may be inclined to exercise undue influence because of the major effect such actions can have on his rate of "unimproved appreciation". A 2nd refers to anyone whose actions increase the rate in wages without more than off-setting increases in cost, and eventual selling price of the product involved. A 3rd would be productive actions on the part of owners of adjoining and/or nearby properties. Fourth would be (as is presently happening) changes in the tax code providing preferential tax treatment to those involved in control and unimproved appreciation. Of course such legislation can only draw increasing investor interest to that sector, providing existing control-speculators with an additional windfall. Government influenced high interest rates, which also artificially raise the cost of point productive business, tend to concentrate "savings" in a holding pattern awaiting the next great opportunity. As industrial failures increase during this period, the largest of the control speculators may not even take advantage of the general move toward money market instruments, knowing that eventually the interest rates must come down, and that they will reap a greater "unimproved appreciation" than even through keeping and adding to their stock of "underdeveloped investments

11/19 "Productive Capitalism vs Control Speculation". A major thrust of this discourse has been to make abundantly clear, the differences between these terms and the concepts associated with them. We define "productive capitalism" simply as an entrepreneurial activity which results in the creation of a new or improved product or service. A more price competitive product would also conform to this definition. In contrast "control speculation" we define as gaining control of an existing entity, on which future value will increase due to the action of others without any productive investment of time or money on the part of the investor-controller. The net effect of such action is the restraining of current productive investment, for which the "control speculator" receives ever higher rewards in a "land inflationary" oriented economy (which expression is fully operative for us in the United States - 1983). It even forces doctors, and other professionals to become "control capitalists" often devoting more of their mental anguish, if not total energies, toward protecting their present gross income through "unimproved appreciation" with that eventual source of yield quickly exceeding that they are making from their profession. Result: less dedicated and more harried physicians, ever more cynical about the entire economic process. They profess entrepreneurial capitalism out of an interest in retaining what is basically their's (from taxes) but are ensnared in a negative activity that can only end up taking more qualified men away from the profession, and cause our medical costs to continue to soar.

11/20 "Control Speculation", of course can apply to any underdeveloped property, however, if an adequate stimulus exists on the underlying land, it becomes impossible for a single entity to maintain control over a specific regional market, or industry. What we are saying is that an appropriate "land stimulus fee", in and of itself, will bring into play increased competition in all parts of the market place.

13/16 "... and even you may be forced to desert your field...". Productive enterprise in the United States has already been reduced to the point that only thirty (30%) percent of the work force is now engaged in productive labor and the U.S. runs a continual negative balance of trade. Neither economically nor militarily can a country sense any feeling of security under these conditions.

13/21 Obviously, the "Investment Stimulus Fee" is not a version of the discriminatory "idle lands tax". Apart from the lack of equity of such programs, they are more complicated to implement and enforce, and have proven unworkable.

16/22 "The "ISF" induced grand total of new revenues would equal a minimum of $125 billion." Even using sound concepts, predicting economic behavior in precise terms, at the very best, either must list all possible interferences, or risk a major possibility of inaccuracy. The major possible interferences include any factor ranging from continued loose immigration policy, to additional wage increases not resulting from either increased productivity, or increased competition for the services of labor in the market place, to further government interference in the process of determining the supply of money.

Brief Descriptions of Present and Future Economic Systems:

Where we Americans started. . .

1. Free Enterprise: An economic system that thrives on complete political freedom. When left unrestricted by government, free enterprise can provide "the greatest good for the greatest number of people, benefiting most of the people most of the time" ... and benign neglect to the rest!!

   DEFECT: What happens to those who, through no fault of their own, are not suited to be included in the economy during recession or at any time?

. . .and, Where we are now. . .

2. Welfare Statism: A system built on redistributive taxation whose stated purpose is to correct the "benign neglect" of the "disadvantaged-minority" within a free enterprise society... a system whose government officials show irrational disrespect for the entrepreneur, taxpayer, and their international trading partners.

   DEFECT: Every time a redistributive remedy is applied, the resulting tax increase causes an accompanying decline in the efficiency of the productive private sector (i.e., each and every tax continues to decrease the efficiency of the private sector , consequently contributing to further unemployment until private sector producers can no longer compete in international trade)... The vicious cycle has been created. Then Welfare Statists resort to deficit spending, or the printing of "fiat money" (i.e., currency without backing) translating into a lower standard-of-living, and a lower value for the currency in international trade. . as the society prepares to succumb to a totalitarian socialist revolution. The redistributive process creates the "father-child" syndrome. The father "giver" begins to demand specific and non-specific return and respect from the child "recipient". The (spoiled) child asks for more benefits, and offers less respect and responsibility. "Judgements and Responsibility for Actions" become increasingly distorted. This relationship holds true in government-to-government as well as at the government-to-individual level. Security problems of all types increase as Welfare States become more and more irresponsible in the taking; and giving what is not theirs to give, creating a nation of 'mental invalids'.

Where we are dangerously heading. . .

3. Modern Socialism: This system provides (whether Marxist, or some form of it called Christian Socialism) a share, for everyone, in the society's available housing, food, and education, along with other benefits, including nominal income in exchange for the citizen performing job(s) assigned to him by the established authority. Choice of occupation and specific job assignment do not generally belong to the worker. That compulsory job, the resultant housing, et al benefits, are protected only as long as the job holder avoids criticizing the laws, programs, and/or the authorities themselves, no matter how distasteful these people and their principles might be to the job holder's deeply held values and/or beliefs.

   DEFECT: Suppresses constructive criticism. Represses the development of widely-experienced individuals, without "freedom of choice". Dampens the output of creative persons within a closely controlled environment. Results in wasteful suspicion and vigilance on the part of everyone to maintain the necessary well-disciplined suppression. This is the only system that does not allow the citizen to consider other forms of government. To install a working socialist government always requires loss of property, and rights, often to life itself. The "taker-and-force", morality never ends!!

The only alternative for all individuals and all countries. . .

4. "Incentive for Progressive Individualism": An "enhancement" of free enterprise economics which guarantees individual rights and "freedom of choice" within a permanently productive full employment economy*(based on fundamental had tax
   * incentives formula Fee" and the gradual "phase out" of all welfare state redistributive taxation). "Incentive for Progressive Individualism" or Equitable Private Enterprise also establishes a participation formula for developing a responsible "identity of interests" between the consumers, owners, management, and other employees.

   DEFECT: None!!

   (Productivity increases; workday decreases; economic, social, and crime rate concerns approach zero!)

○